97th Congress
2d Session

COMMITTEE PRINT

TAX EXPENDITURES

Relationships to Spending Programs and Background Material on Individual Provisions

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COMMITTEE ON THE BUDGET

UNITED STATES SENATE

MARCH 17, 1982

Printed for the use of the Committee on the Budget

U.S. GOVERNMENT PRINTING OFFICE

91-286 O WASHINGTON : 1982

For sale by the Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. 20402

5252-3

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LETTER OF TRANSMITTAL

TO THE MEMBERS OF THE COMMITTEE ON THE BUDGET:

The Congressional Budget and Impoundment and Control Act of 1974 requires the Budget Committees to examine tax expenditures as they develop the Federal budget. Numerous provisions of the tax code confer benefits upon individuals and institutions that are comparable to direct Federal spending. These provisions have substantial impact on the level of Federal receipts and are seldomly reviewed in comparison to the scrutiny given to the direct spending programs.

This Committee print has been prepared to revise the September, 1978 "Yellow Book" publication on Tax Expenditures. It is a compendium that briefly describes the operation and impact of each tax expenditure; indicates that authorization and rationale for enactment; shows the revenue loss attributable to each provision and, where available, the percentage distribution of that loss by income class; and cites a selected bibliography for each provision within its functional class.

Tax expenditures are becoming increasingly important in developing the budget. They are generally enacted as permanent legislation and thus are comparable to continuing direct spending entitlement programs. They cause significant revenue losses and are often less efficient than related outlay programs. In some cases, they cause economic distortion and result in higher inflation and interest rates and in less growth.

This compendium was prepared jointly by the Budget Committee staff, the Joint Committee on Taxation, the Congressional Budget Office, and the Congressional Research Service.

Nothing in this volume should be interpreted as representing the views or recommendations of the Budget Committee or any of its members.

Sincerely,

ERNEST F. HOLLINGS,
Ranking Minority Member.

PETE V. DOMENICI,
Chairman.

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INTRODUCTION

This compendium gathers basic information concerning 104 Federal tax provisions currently treated as tax expenditures. These provisions are the same as those listed in Tax Expenditure Budgets prepared for fiscal year 1983 by the Joint Committee on Taxation and the Congressional Budget Office. The administration has produced a tax expenditure budget in Special Analysis G which differs to a greater degree than ever before from those produced by the Congress and previous administrations. These differences will be elaborated upon below.

With respect to each tax expenditure, this compendium provides:

An estimate of the Federal revenue loss associated with the provision for individual and corporate taxpayers, for fiscal years 1982-1987;

The legal authorization for the provision (e.g., Internal Revenue Code section, Treasury Department regulation, or Treasury ruling);

A description of the tax expenditure, including an example of its operation where this is useful;

A brief analysis of the impact of the provision;

A brief statement of the rationale for the adoption of the tax expenditure where it is known, including relevant legislative history; and

References to selected bibliography.

The information presented for each of these tax expenditures is not intended to be exhaustive or definitive. Rather, it is intended to provide an introductory understanding of the nature, effect, and background of each of these provisions. Good starting points for further research on each item are listed in the selected bibliography following each provision.

Appendix A contains estimates of revenue loss distributed by expanded income class for 16 tax expenditures affecting individuals. These are generated by the Treasury individual income tax model. No other income distribution estimates are provided for the remaining individual or corporate tax expenditures, since to do so would require making assumptions for which substantiating data do not exist.

Defining Tax Expenditures

Tax expenditures are revenue losses resulting from Federal tax provisions that grant special tax relief designed to encourage certain kinds of behavior by taxpayers or to aid taxpayers in special circumstances. These provisions may, in effect, be viewed as the

equivalent of a simultaneous collection of revenue and a direct budget outlay of an equal amount to the beneficiary taxpayer.

Section 3(a)(3) of the Congressional Budget and Impoundment Control Act of 1974 specifically defines tax expenditures as:

> . . . those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability; . . . .

In the legislative history of the Congressional Budget Act, provisions classified as tax expenditures are contrasted with those provisions which are part of the "normal structure" of the individual and corporate income tax necessary to collect government revenues.

The listing of a provision as a tax expenditure in no way implies any judgment about its desirability or effectiveness relative to other tax or nontax provisions that provide benefits to specific classes of individuals and corporations. Rather, the listing of tax expenditures, taken in conjunction with the listing of direct spending programs, is intended to allow Congress to scrutinize all Federal programs relating to the same goals—both nontax and tax—when it develops its annual budget. Only when tax expenditures are considered will Congressional budget decisions take into account the full spectrum of Federal programs.

Because any qualified taxpayer may reduce tax liability through use of a tax expenditure, such provisions are comparable to entitlement programs under which benefits are paid to all eligible persons. Since tax expenditures are generally enacted as permanent legislation, it is important that, as entitlement programs, they be given thorough periodic consideration to see whether they are efficiently meeting the national needs and goals that were the reasons for their initial establishment.

The concept of tax expenditures is relatively new, having been developed over the past decade. Tax expenditure budgets which list the estimated annual revenue losses associated with each tax expenditure first were required to be published in 1975 as part of the Administration budget for fiscal year 1976, and have been required to be published by the Budget Committees since 1976. The tax expenditure concept is still being refined, and therefore, the classification of certain provisions as tax expenditures continues to be discussed. Nevertheless, there has been widespread agreement for the treatment as tax expenditures of most of the provisions included in this compendium.[1]

Administration Fiscal Year 1983 Tax Expenditure Budget

The administration fiscal year 1983 tax expenditure budget, presented in Special Analysis G, differs in several respects from those prepared by the Joint Committee on Taxation, the Congressional Budget Office, and previous administrations. Eight items have been deleted including accelerated cost recovery depreciation. However, the safe harbor leasing rules, a part of this depreciation system, have been included. The excluded items include:

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[1] For a discussion of some of the conceptual problems involved in defining tax expenditures, see *The Budget of the United States Government, Fiscal Year 1983,* "Special Analysis G."

(1) Accelerated cost recovery depreciation;
(2) Deferral of income of controlled foreign corporations;
(3) Exclusions of payments in aid of construction of water, sewage, gas, and electric utilities;
(4) Deductibility of noncash patronage dividends and certain other items of cooperatives;
(5) Exclusion of certain cost-sharing payments;
(6) Reduced rates on the first $100,000 of corporate income;
(7) Exclusion of scholarship and fellowship income; and
(8) Exclusion of public assistance benefits.

The administration considers these items as part of the reference tax structure rather than special exceptions to it.

Special Analysis G includes estimates of the outlay equivalents as well as revenue loss. This form is considered preferable for comparison of tax expenditures with outlay programs. Separate estimates for corporations and individuals of revenue loss and outlay equivalents have been eliminated. Finally, the administration objects to the term "tax expenditure" and offers "tax subsidy" as a substitute.

Major Types of Tax Expenditures

Tax expenditures may take any of the following forms: (1) exclusions, exemptions, and deductions, which reduce taxable income; (2) preferential tax rates, which reduce taxes by applying lower rates to part or all of a taxpayer's income; (3) credits, which are subtracted from taxes as ordinarily computed; and (4) deferrals of tax, which result from delayed recognition of income or from allowing in the current year deductions that are properly attributable to a future year.[2]

The amount of tax relief per dollar of each exclusion, exemption, and deduction increases with the taxpayer's marginal tax rate. Thus, the exclusion from tax of interest income from State and local bonds saves $50 for every $100 of interest for the taxpayer in the 50 percent tax bracket, whereas the savings for the taxpayer in the 25 percent bracket is only $25. Similarly, the extra exemption for persons age 65 or over and any itemized deduction is worth twice as much in tax saving to a taxpayer in the 50 percent bracket as to one in the 25 percent bracket.

A tax credit is subtracted directly from the tax liability that would otherwise be due; thus the amount of tax reduction is the amount of the credit—which does not depend on the marginal tax rate.

The numerous tax expenditures that take the form of exclusions, deductions, and exemptions are relatively more valuable to upper than to lower or middle income individuals. However, this fact should be viewed in the context of recent substantial increases in the standard deduction, which provide more tax saving for certain low-middle income taxpayers than itemized deductions, thus reducing the number of itemizers.

Moreover, even though some tax expenditures may provide most of their tax relief to those with high taxable incomes, this may be

[2] See Appendix B for further analysis of these types of tax expenditures.

the consequence of overriding economic considerations. For example, tax expenditures directed toward capital formation may deliberately benefit savers who are primarily higher income taxpayers.

Order of Presentation

The tax expenditures are presented in an order which generally parallels the budget functional categories used in the Congressional budget, i.e., tax expenditures related to "national defense" are listed first, and those related to "international affairs" are listed next. In a few instances, two or three closely related tax expenditures derived from the same Internal Revenue Code provision have been combined in a single summary to avoid repetitive references even though the tax expenditures are related to different functional categories. This parallel format is consistent with the requirement of section 301(d)(6) of the Budget Act, which requires the tax expenditure budgets published by the Budget Committees as parts of their April 15 reports to present the estimated levels of tax expenditures "by major functional categories."

Rationale

The material on each tax expenditure contains a brief statement of the rationale for the adoption of the tax expenditure where it is known. These rationales are the principal ones which were publicly given at the time the provisions were enacted.

Further Comment

In the case of a number of tax expenditures, additional information is provided under the heading "Further Comment." It is material which either focuses attention on some of the principal issues related to a provision or describes recent legislative proposals to amend a provision. This is material that does not fit within the other elements of the format of the compendium—either in the "Description," "Impact," or "Rationale" sections. As the examples which are provided in the descriptions of only some of the tax expenditures, the "Further Comment" sections are included only where they were deemed to be useful. Providing information under the "Further Comment" sections for only certain tax expenditures in no way implies any judgment about these provisions.

Estimating Tax Expenditures

The estimated revenue losses for all the listed tax expenditures are based upon work done by the staffs of the Treasury Department and the Joint Committee on Taxation.

In calculating the revenue loss from each tax expenditure, it is assumed that only the provision in question is deleted and that all other aspects of the tax system remain the same. In using the tax expenditure estimates, several points should be noted.

First, in some cases, if two or more items were eliminated, the combination of changes would probably produce a lesser or greater revenue effect than the sum of the amounts shown for the individual items.

Second, the amounts shown for the various tax expenditure items do not take into account any effects that the removal of one or more of the items might have on investment and consumption patterns or on any other aspects of individual taxpayer behavior, general economic activity, or decisions regarding other Federal budget outlays or receipts.

Finally, the revenue effect of new tax expenditure items added to the tax law may not be fully felt for several years. As a result, the eventual annual cost of some provisions is not fully reflected until some time after enactment. Similarly, if items now in the law were eliminated, it is unlikely that the full revenue effects would be immediately realized.

However, these tax expenditure estimating considerations are similar to estimating considerations involving entitlement programs. Like tax expenditures, annual budget estimates for each transfer and income security program are computed separately. However, if one program, such as veterans' pensions, were either terminated or increased, this would affect the level of payments under other programs, such as welfare payments. Also, like tax expenditure estimates, the elimination or curtailment of a spending program, such as military spending or unemployment benefits, would have substantial effects on consumption patterns and economic activity that would directly affect the levels of other spending programs. Finally, like tax expenditures, the budgetary effect of terminating certain entitlement programs would not be fully reflected until several years later because the termination of benefits is usually only for new recipients with persons already receiving benefits continued under "grandfather" provisions.

All revenue loss estimates are based upon the tax law enacted as of December 31, 1981. All estimates have been rounded to the nearest $5 million.

SUM OF TAX EXPENDITURE ITEMS BY TYPE OF TAXPAYER, FISCAL YEARS 1982–87

[In millions of dollars]

Fiscal year	Corporations and individuals	Corporations	Individuals
1982	253,515	55,140	198,375
1983	273,135	64,025	209,110
1984	305,990	80,370	225,620
1985	347,775	96,275	251,500
1986	395,975	110,715	285,260
1987	439,430	121,990	317,440

NOTE.—These totals represent the mathematical sum of the estimated fiscal year effect of each of the tax expenditure items included in the table. The limitations on the use of the totals are explained in the text.

Source: Staffs of the Treasury Department and the Joint Committee on Taxation.

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(050) National Defense

EXCLUSION OF BENEFITS AND ALLOWANCES TO ARMED FORCES PERSONNEL

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	1,885		1,885
1983	1,940		1,940
1984	2,025		2,025
1985	2,160		2,160
1986	2,310		2,310
1987	2,465		2,465

Authorization

Sections 112 and 113,[1] Regulation §1.61-2,[2] and court decisions.

Description

Military personnel are not taxed on a variety of in-kind benefits and cash payments given in lieu of such benefits. These tax-free benefits include quarters and meals or—alternatively—cash allowances for these purposes, certain combat pay, and a number of less significant items.

Impact

All military personnel receive one or more of these benefits which are generally greater in the higher pay brackets. The amount of tax relief increases with the individual's tax bracket, and therefore depends on a variety of factors unrelated to the taxpayer's military pay, such as other income including income from a spouse, and the amount of itemized deductions. Therefore, the exclusion of these benefits from taxation alters the distribution of net pay to service personnel.

Rationale

Although the principle of exemption of armed forces benefits and allowances appeared early in the history of the income tax, it has

[1] The word "Section" denotes a section of the Internal Revenue Code of 1954 as amended unless otherwise noted.

[2] Reference to "regulations" are to Income Tax Regulations unless otherwise noted.

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evolved through subsequent specific statutes, regulations, revenue rulings, and court decisions. For some benefits, the rationale was a specific desire to reduce tax burdens of military personnel during wartime (as in the use of combat pay provisions); other preferences were apparently based on the belief that certain types of benefits were not strictly compensatory but rather intrinsic elements in the military structure.

Further Comment

Administrative difficulties and complications could be encountered in taxing some military benefits and allowances that are tax exempt; for example, it could be difficult to value meals and lodging when the option to receive cash is not available. However, eliminating the exclusions and adjusting pay scales accordingly might simplify decisionmaking about military pay levels and make "actual" salary more apparent to recipients.

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(050) National Defense

EXCLUSION OF MILITARY DISABILITY PENSIONS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individual	Corporations	Total
1982	165		165
1983	170		170
1984	175		175
1985	190		190
1986	200		200
1987	215		215

Authorization

Section 104(a)(4) and 104(b).

Description

Service personnel who joined the armed forces on or before September 24, 1975, and have at least a 30-percent disability or at least 20 years of service and any amount of disability may draw retirement pay from the Department of Defense based on either percentage of disability or years of service. If the chosen pension is less than 50 percent of the basic pay, it will be raised to 50 percent during the first 5 years of retirement. Pay based on percentage of disability is fully excluded from gross income under section 104. If pay is based on years of service, only the portion that would have been paid on the basis of disability is excluded from income.

Members of the armed forces who join the service after September 24, 1975, are allowed to exclude military disability payments only if the payments are directly attributable to combat-related injuries. The term "combat-related injury" means personal injury or sickness which is incurred (1) as a direct result of armed conflict, (2) while engaged in extra-hazardous service, (3) under conditions simulating war, or which is (4) caused by an instrumentality of war.

Disability payments administered by the Veterans' Administration are excluded from gross income. These payments are based on degree of disability rather than length of service. A serviceman who joins the armed forces after September 24, 1975, retires on disability, and receives taxable disability payments from the Depart-

ment of Defense, is allowed to exclude from income an amount equivalent to what he would have been entitled to if his payments had been received from the Veterans Administration.

Impact

Disability payments that are exempt from tax provide more net income than taxable benefits at the same level. The tax benefit of this provision increases as the pensioner's marginal tax rate increases. Thus, the after-tax pension benefits increase as a percentage of active duty pay as the individual's tax bracket increases.

Rationale

Prior to 1976, military personnel could exclude from income pensions for personal injuries paid by the Department of Defense. The rationale was not clear for the exclusion, which was adopted during World War II in 1942. In limiting the exclusion in 1976, Congress sought to eliminate abuses by armed forces personnel who were classified as disabled shortly before becoming eligible for retirement in order to obtain tax exempt treatment for their pension benefits. After retiring from military service, most of these individuals would earn income from other employment while receiving tax-free military pensions. Since present armed forces personnel may have joined or continued their service because of the expectation of tax exempt disability benefits, Congress deemed it equitable to limit changes in the tax treatment of disability payments to future personnel.

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EXCLUSION OF INCOME EARNED ABROAD BY UNITED STATES CITIZENS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	985		985
1983	1,285		1,285
1984	1,340		1,340
1985	1,460		1,460
1986	1,600		1,600
1987	1,795		1,795

Authorization

Sections 911-912.

Description

A U.S. citizen or resident is generally taxed on his worldwide income, with the allowance of a foreign tax credit for foreign taxes paid on the foreign income. However, under section 911 of the Internal Revenue Code, an individual who has his tax home in a foreign country and who is either present overseas for 11 out of 12 consecutive months or who is a bona fide resident of a foreign country for an entire taxable year can elect to exclude an amount of his foreign earned income from his gross income. The maximum exclusion is $75,000 in 1982 increasing in $5,000 annual increments to $95,000 in 1986.

An individual meeting the eligibility requirements may also elect to exclude his housing costs above a floor which is an amount equal to 16 percent of the salary of a Federal employee at Grade 14, Step 1. The combined earned income exclusion and housing amount exclusion may not exceed the taxpayer's total foreign earned income for the taxable year. An exclusion for employer-provided amounts attributable to living in a camp located in a foreign country is also provided. The provision contains a denial of double benefits by reducing such things as the foreign tax credit by the amount attributable to excluded income.

Some form of foreign earned income exclusion has been in the tax laws since 1926. The system described above replaces a system of deductions and exclusions for excess costs of living abroad that

was adopted by the Congress in 1977 and was effective for years 1978 through 1981. Adoption of the present system greatly increased the estimated revenue loss from this provision.

Section 911 does not apply to salaries received from the U.S. Government. However, section 912 exempts from tax certain allowances that are received by Federal civilian employees working abroad and in Alaska and Hawaii. The principal exempt allowances are for high local living costs, education, and housing.

Impact

Some U.S. citizens living abroad pay no income taxes to the countries in which they reside. The present foreign earned income exclusion of section 911 allows their income up to the appropriate ceiling to be free from United States tax as well.

U.S. citizens residing abroad and paying no income taxes to a foreign government receive a tax benefit in the form of lower overall U.S. taxes. The tax burden is zero if the individual's earnings equal or are below the limitation. Where the individual's earnings exceed the limitation, his rates on the excess will be lower than a comparably compensated citizen living in the United States. This is because the first dollar of excess is treated, in effect, as the first dollar of income taxed at the lowest marginal rates. The same holds true for unearned income, that is, a U.S. citizen eligible for the foreign earned income exclusion will pay a lower rate of tax on his investment income than a similarly situated citizen all of whose earnings are subject to full U.S. tax.

If the individual pays foreign income taxes on the wages, those taxes cannot be credited against U.S. income tax liability on other foreign income. The value of the exclusion is, therefore, the difference between the tax savings and the amount of foreign tax credit which would have been claimed on the excluded amount in the absence of the exclusion. This difference is the greatest, and thus the exclusion has the greatest value, for taxpayers living in those countries where tax rates on the excludable portion are nonexistent or much lower than the U.S. rate. Those countries with substantial numbers of U.S. employees which tend to have lower tax rates include Singapore, Venezuela, Saudi Arabia, Switzerland, the Philippines, and the Marshall Islands.

In addition to the U.S. citizens who directly claim the benefits from this favorable treatment on their tax returns, overseas employers also benefit to the extent that salary levels are lower because of the exclusion. In fact, many U.S. firms follow a practice of "tax protection," under which employees' salaries are set at levels to give them the same after-tax salary they would receive in the United States. When this practice is followed, all the direct benefits of section 911 accrue to the employers rather than the employees. U.S. corporations that bid on overseas construction projects assert that the salary savings make them more competitive with foreign bidders, some of the employees of which also enjoy similar tax benefits under the laws of their home countries.

The Treasury Department has estimated that in 1975, approximately 100,000 civilian government employees received one or more allowances that are excluded from income under section 912.

Approximately 40,000 of these persons were employed in foreign countries, about 20,000 in U.S. territories, and about 40,000 in Alaska and Hawaii. Roughly 60 percent of the total were civilian employees of the Department of Defense.

The value of the section 912 exemption for allowances received by Federal civilian employees working abroad increases with the recipient's tax bracket. The value therefore depends on variety of factors including the level of the recipient's Federal salary, the extent of his other income, and the amount of his itemized deductions.

Rationale

A less restrictive form of section 911 was first enacted in 1926 to encourage foreign trade. After World War II, the exclusion was justified as part of the Marshall Plan to encourage persons with technical knowledge to work abroad. The most recent expansion of the provision was intended to provide an incentive to U.S. businesses to send U.S. workers abroad. Although the provision was revised on several occasions, dollar limitations were first enacted in 1953 at $20,000 and $35,000. The latter figure was reduced to $25,000 in 1964.

The exemption for civilian Federal employee overseas allowances was enacted in 1943. The principal rationale was to provide additional compensation for these employees, who were performing vital wartime services.

Further Comment

After enactment of the Tax Reform Act of 1976, which substantially limited the foreign earned income exclusion, controversy developed about those revisions. Congress acted to delay the application of those changes and, in fact, the revisions made in the 1976 act never applied. Instead, a series of special deductions for cost of living, housing, and educational expenses, as well as combinations of special deductions and flat exclusions was enacted. The 1981 amendments replaced that system. The large, but limited, exclusion enacted was really a compromise with those who wanted a complete exclusion of foreign earned income. It is likely that attempts to gain a complete exclusion will continue.

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DEFERRAL OF INCOME OF DOMESTIC INTERNATIONAL SALES CORPORATIONS (DISC)

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982		1,560	1,560
1983		1,665	1,665
1984		1,750	1,750
1985		1,820	1,820
1986		1,885	1,885
1987		1,950	1,950

Authorization

Sections 991-997.

Description

A U.S. corporation will qualify as a DISC (Domestic International Sales Corporation) if at least 95 percent of its assets are related to export functions, and if at least 95 percent of its gross receipts stem from export related sale or lease transactions.

DISC's typically are wholly owned subsidiary corporations through which parent corporations channel their export sales. DISC's are not themselves subject to corporate income tax, but their parent corporations are taxed on the DISC income when it is distributed or attributed to them.

The tax savings from using a DISC result principally from two interrelated aspects of the tax law: (1) the allocation rules that allow at least half of the total combined profit of the parent and DISC from export sales to be attributed to the DISC; and (2) the potentially permanent deferral which is allowed on half of the DISC profits attributable to exports exceeding a base level. This level is 67 percent of average export receipts during a prior 4-year base period. Through 1979, the base period was 1972-75. Beginning in 1980, the base period move up 1 year each year, so that the base period in 1980 was 1973-76, in 1981, 1974-77, in 1982, 1975-78, and so forth. This incremental rule does not apply to DISC's with income of $100,000 or less, and is phased out over the $100,000 to $150,000 income range.

The special allocation rules provide that a DISC is deemed to have earned either (1) 50 percent of the combined taxable income of the parent corporation and DISC from export sales or, (2) 4 percent of the gross receipts from export sales, whichever is greater. In the alternative, the normal arm's-length intercompany pricing rules provided by section 482 of the Code can be used. The 50 percent allocation is used far more often than the others. The rules for allocating DISC profits are generally much more favorable than the otherwise applicable tax law standard (section 482), which allocates profits betweeen two corporations under the same control as if transactions between them occurred at an arm's length price. Generally, if the section 482 rules were applied to DISC's, only a relatively small, or no sales commission would be allocated to the DISC, while the proportionately larger profits from production would go to the parent corporation.

The deferral of tax continues as long as the undistributed DISC income is invested in qualified assets; the duration may be indefinite, and in such cases constitutes the practical equivalent of a permanent tax exemption. The income allocable to a DISC that is not eligible for deferral is deemed to be distributed annually to its parent corporation.

Certain exports are not eligible for DISC treatment. These include oil, gas, hard minerals, and products subject to export control under the Export Administration Act of 1969. DISC deferral on exported military goods is limited to half the amount which would otherwise be allowed.

Example

A company formed a DISC in 1977, and sold $8,000,000 of exports in that year and $10,000,000 in 1978. Its sales in 1982 are $10,000,000, with total costs of $8,000,000 and pre-tax income of $2,000,000. The allocation rule attributes 50 percent of the $2,000,000 total net profit in 1982 to the DISC and 50 percent to the parent firm. Of the $1,000,000 allocated to the DISC, one-half, or $500,000 is potentially eligible for deferral before the incremental rule is applied. Average exports for 1975–78 are $4,500,000 ($8,000,000 plus $10,000,000 divided by 4, with non-DISC years counted as zero); 67 percent of this amount is roughly $3,000,000. Under the incremental rule, therefore, 70 percent ($10,000,000 minus $3,000,000/$10,000,000) of the DISC income is eliglbe for deferral. Therefore $350,000 ($0.70 \times \$500,000$) benefits from deferral reducing tax liability by $161,000 ($0.46 \times \$350,000$). This tax saving reduces the tax rate by 8.1 percentage points ($161,000/$2,000,000), reducing the effective tax rate on export income from the statutory 46 percent to 37.9 percent. If the incremental rules had not been applicable, the effective tax rate would have been 34.5 percent.

Impact

Apart from the incremental rule, the provision reduces the marginal tax rate on most DISC related export income to 34.5 percent (and to 23 percent in the relatively fewer cases where the total profit on export sales of the DISC and its parent is no more than 4 percent of gross export receipts).

The incremental rule reduces these benefits for companies that do not experience increasing exports, and affects either less substantially or not at all rapidly growing exporters (whose relatively smaller base would be advantageous), new DISC's, and small exporters. The incremental rule was designed to provide more stimulus to exports at a lower cost because the export incentive is aimed at marginal exports. However, the Treasury Department has indicated that the incremental rule reduces the incentive effect with respect to additional exports as well by 40 percent since the exporter must take into account the fact that additional exports now will increase the export base and reduce future DISC benefits.

Whether U.S. exporters reduce export prices in response to reduced effective tax rates is unclear. To the extent they do, foreign purchasers would be subsidized.

According to the Treasury Department, the overall impact of DISC in stimulating exports has been small in comparison to its annual revenue cost. Over the long run, the Treasury contends that adjustments in exchange rates tend to offset any effects the DISC law may have on the balance of trade. U.S. exports have increased dramatically since the DISC provisions were added, but the increase is said to be primarily due to the devaluation of the dollar and worldwide inflation.

On the other hand, many U.S. companies which utilize these provisions argue that DISC should be retained because in their view: (1) the law has substantially increased exports which, in turn, have increased U.S. employment levels; and (2) U.S. industry can remain competitive only if the United States provides subsidies to offset the variety of export promotion devices employed by other countries.

The Treasury Department study cited below in the bibliography reported that for year 1977 before the incremental rule generally became effective, 74 percent of the net income of the 4,978 DISC's with corporate owners for which asset size data were available accrued to 518 companies with gross assets in excess of $250 million.

Rationale

Originally adopted as part of the Revenue Act of 1971, the DISC concept was intended to stimulate exports and enhance the attractiveness of domestic manufacturing vis-a-vis manufacturing through foreign subsidiaries. Restrictions on the benefits for natural resource products and scarce products were adopted in the Tax Reduction Act of 1975. The incremental rule adopted in the Tax Reform Act of 1976 was designed to continue to provide stimulus to exports with a smaller revenue loss.

Further Comment

The DISC provisions have been the subject of international concern. The European Economic Community lodged a formal complaint under GATT (General Agreement on Tariffs and Trade) in July 1972, arguing that the DISC provision violated GATT rules prohibiting tax subsidies for exports. In 1973, the United States also brought complaints against France, Belgium, and the Netherlands against their tax practices. The panels appointed to consider

these questions concluded in 1976 that there was a *prima facie* case for all of these complaints. The United States has recommended adoption of all panel reports, while the European countries expressed reservations. At the December 1981 meeting of the GATT Council all of the panel reports were adopted. However, the Council qualified the adoption by acceptance of the principal that GATT rules do not require taxing economic activity involving exports taking place outside its territory. This would imply that the U.S. system, including DISC, is consistent with U.S. GATT obligations. This Council action apparently does not preclude future challenges to DISC.

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DEFERRAL OF INCOME OF CONTROLLED FOREIGN CORPORATIONS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982		520	520
1983		560	560
1984		605	605
1985		655	655
1986		705	705
1987		760	760

Authorization

Sections 11(f), 882 and 951–964.

Description

A U.S. corporate parent of a foreign subsidiary is not taxed on the subsidiary's income until the income is remitted (or "repatriated") to the parent. The deferral of U.S. tax liability on the subsidiary's income continues indefinitely as long as the income is reinvested in the subsidiary or other foreign subsidiaries, rather than remitted to the U.S. parent. A tax credit in the amount of total worldwide foreign taxes paid on repatriated income after gross-up (i.e. after adding back foreign income taxes paid to the actual dividend) is allowed at the time of repatriation.

An exception to the general deferral principle is provided under subpart F of the Code (sections 951–964). Under these sections, income from so-called tax haven activities conducted by corporations controlled by U.S. shareholders is deemed distributed to the shareholders and taxed to them as earned. Tax haven activities are generally sales and services artificially structured to channel income from high tax jurisdictions to lower tax jurisdictions. They also include the receipt of personal income.

By comparison to the treatment of foreign subsidiary income, income from all foreign branches of U.S. corporations is taxed the same as income earned in the United States since the branches are parts of U.S. corporations.

Impact

Companies that operate subsidiaries in countries with effective income tax rates lower than the U.S. rate may receive tax benefits from this provision.

A substantial portion of the revenue loss is attributable to deferral on shipping income, which is estimated to account for about $200 million of the current revenue loss. This occurs because shipping firms are often based in countries without income taxes, such as Liberia and Panama. U.S. Department of Commerce data indicate that 473 of the 687 foreign flag ships owned by U.S. corporations and their subsidiaries are registered in Panama or Liberia. Much (488) of this total shipping fleet is composed of tankers.

Rationale

Historically, the United States has not taxed foreign source income of foreign corporations on the premise that only domestic corporations or income with a U.S. source is subject to U.S. jurisdiction. The separate corporate status of foreign subsidiaries of domestic corporations generally has been respected. In 1962, these principles were abrogated for tax haven income under subpart F of the Code. Subpart F was subsequently strengthened by the Tax Reduction Act of 1975 and the Tax Reform Act of 1976. Such income is taxed even though earned abroad and even though not repatriated. This provision was enacted in part to prevent multinational companies from shifting profits to tax havens.

Further Comment

Opponents of deferral allege it encourages investment in foreign countries and reduces domestic investment. They argue this reduces U.S. tax revenues and U.S. exports, and adversely affects the balance of payments, the balance of trade, and domestic employment. Proponents deny such allegations, and argue that deferral must be continued for U.S. corporations to remain competitive with foreign companies in overseas markets.

Deferral of tax on foreign profits is not neutral compared to investment in the United States in the sense that if the foreign country tax rate is less than the U.S. tax rate and the income is not going to be repatriated, a U.S. corporation has a tax incentive to invest abroad using a foreign subsidiary instead of investing at home. However, the deferral rules do neutralize advantages foreign competitors may have over U.S. corporations operating abroad. Moreover, there are also offsetting tax rules which favor investment in the United States by domestic companies rather than abroad, such as, limiting the investment tax credit and Accelerated Cost Recovery System (ACRS) to assets used in the United States.

Moreover, simply ending deferral would not necessarily result in increased U.S. taxes on the low taxed income of foreign subsididaries. This is because the U.S. foreign tax credit is computed on an overall worldwide basis. Accordingly, income taxes in excess of U.S. rates paid to high tax foreign countries would offset U.S. taxes imposed on income from low tax countries. This could be mitigated,

and revenue increased, by coupling ending deferral with changes in the foreign tax credit limitation.

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EXPENSING OF RESEARCH AND DEVELOPMENT EXPENDITURES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	100	1,900	2,000
1983	105	2,055	2,160
1984	120	2,245	2,365
1985	125	2,350	2,475
1986	125	2,415	2,540
1987	130	2,475	2,605

Authorization

Section 174.

Description

As a general rule, business expenditures to develop or create an asset which has a useful life that extends beyond the taxable year, such as expenditures to develop a new consumer product or improve a production process, must be capitalized and cannot be deducted in the year paid or incurred. These costs usually may be recovered through depreciation or amortization deductions over the useful life of the asset, or on a disposition or abandonment of the asset.

However, under section 174, a taxpayer may elect to deduct currently the amount of certain research or experimental expenditures incurred in connection with the taxpayer's trade or business. In the case of research expenditures resulting in property which does not have a determinable useful life (such as secret processes or formulae), the taxpayer alternatively may elect to deduct the costs ratably over a period of not less than 60 months. Treasury regulations define expenditures eligible for the deduction elections as "research and development costs in the experimental or laboratory sense."

Expenditures for the acquistion or improvement of land, or expenditures for the acquisition or improvement of depreciable or depletable property to be used in connection with research, are not eligible for the deduction elections. However, research expenditures which may be expensed or amortized under section 174 include de-

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preciation (cost recovery) or depletion allowances with respect to depreciable or depletable property used for research. Expenditures to ascertain the existing, location, extent, or quality of mineral deposits, including oil and gas, are not eligible for section 174 elections.

Impact

The accelerated deduction allowed for research expenditures operates, as does accelerated capital cost recovery, to defer tax liability.

For example, if a corporation incurs expenditures of $1 million in the taxable year for research wages, supplies, and depreciation allowances, the corporation may currently deduct that amount from its taxable income, producing a cash flow (at a 46-percent marginal tax rate) of $460,000. The value to the corporation of current expense treatment is the amount by which the present value of the immediate deduction exceeds (for example) the present value of periodic deductions which otherwise could be taken over the useful life of the asset, such as a patent, resulting from the research expenditures.

The direct beneficiaries of this provision are businesses that undertake research. Mainly, these are large manufacturing corporations or high technology firms. Also, the deduction is available to investors in so-called R. & D. tax shelter partnerships, and can be used by such individuals to offset income from sources other than the partnership.

For accounting purposes, certain research and development expenditures are to be charged to expense when incurred (Statement of Financial Accounting Standards No. 2, October 1974). These costs include the cost of materials consumed in research, depreciation of equipment or facilities used in research, and costs of personnel engaged in research.

Rationale

Section 174 was enacted as part of the Internal Revenue Code of 1954. The purposes cited for the provision were to encourage research expenditures and to eliminate difficulties and uncertainties under prior law in distinguishing trade or business expenditures from research expenditures.

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CREDIT FOR INCREASING RESEARCH ACTIVITIES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Coporations	Total
1982	15	375	390
1983	30	545	575
1984	35	665	700
1985	40	665	705
1986	30	390	420
1987	5	80	85

Authorization

Section 44F.

Description

A nonrefundable, 25-percent income tax credit is allowed for certain research expenditures paid or incurred in carrying on a trade or business of the taxpayer. The credit applies only to the extent that the taxpayer's qualified research expenditures for the taxable year exceed the average amount of the taxpayer's yearly qualified research expenditures in the specified base period (generally, the preceding three taxable years).

The credit provision adopts the definition of research used for purposes of the special deduction rules under section 174, but subject to certain exclusions. Research expenditures eligible for the incremental credit consist of (1) in-house expenditures by the taxpayer for research wages and supplies used in research, plus certain amounts paid for research use of laboratory equipment, computers, or other personal property; (2) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf; and (3) if the taxpayer is a corporation, 65 percent of the taxpayer's expenditures (including grants or contributions) pursuant to a written research agreement for basic research to be performed by universities or certain scientific research organizations.

The credit is available with respect to qualified research expenditures paid or incurred after June 30, 1981, and before January 1, 1986.

Impact

The credit has the effect of reducing the net cost to a business of incurring qualified research expenditures in excess of its research expenditures in a base period (generally, the preceding three years). The credit does not provide a benefit to firms which continue the same dollar amount of research spending. However, since the base period amount is not adjusted for inflation, businesses may benefit from the credit even though the level of their research activities (in constant dollars) remains the same.

In general, the credit is available only for research expenditures incurred in carrying on a trade or business of the taxpayer. As a result of this requirement, the credit generally is not available for research expenditures incurred by a so-called R. & D. tax shelter partnership or by a newly organized business prior to the date the entity is considered to be engaged in carrying on a trade or business, nor is it available to an existing business which incurs research expenditures to enter into a new trade or business. Also, no more than 50 percent of otherwise qualifying current year expenditures can be eligible for the credit, even if the base period amount is less than 50 percent of current expenditures.

Individuals to whom the credit is properly allocable from a partnership or other business may use the credit in a particular year only to offset the amount of tax attributable to that portion of the individual's taxable income derived from that business. For example, an individual cannot use passthroughs of the credit from a research partnership to offset tax on income from other sources.

Rationale

Section 44F was enacted as part of the Economic Recovery Tax Act of 1981. The purpose cited was that a substantial tax credit for incremental research expenditures was needed to overcome the reluctance of many ongoing companies to bear the significant costs of staffing and supplies, and certain equipment expenses such as computer charges, which must be incurred to initiate or expand research programs in a trade or business.

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SUSPENSION OF REGULATIONS RELATING TO ALLOCATION UNDER SEC. 861 OF RESEARCH AND EXPERIMENTAL EXPENDITURES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982		55	55
1983		120	120
1984		60	60
1985			
1986			
1987			

Authorization

Section 223, Public Law 97-34, Economic Recovery Tax Act of 1981.

Description

In determining foreign source taxable income for purposes of computing the foreign tax credit limitation (sec. 904), and for other tax purposes, sections 861-863 require taxpayers to allocate or apportion expenses between foreign-source income and U.S.-source income. Treasury regulation § 1.861-8 sets forth rules for allocating and apportioning these expenses.

Under this regulation, research and development expenditures ("research expenses") are allocated to income based on a broad classification of 32 product groups enumerated in the Standard Industrial Classification ("SIC") Manual. Research expenses are not allocable solely to the income generated by the particular product which benefited from the research activity. Instead, these expenses are allocable to all the income within the SIC product group in which the product is classified. Accordingly, once a research expense is identified with a SIC product group, it is allocated to foreign sources based on the ratio of total foreign source sales receipts or income, as the case may be, within the SIC product group to the total worldwide sales receipts or income, as the case may be, within the SIC product group.

The regulation provides certain "safe harbors" when more than 50 percent of the research expenses are incurred either within or without the United States. For years beginning in 1979, the regulation allows a taxpayer to allocate 30 percent of the research expenses to the geographic source in which more than 50 percent of such expenses were incurred.

The regulation also provides that if the taxpayer's results of operations justify an allocation of research expenses to the country in which the research is performed that would be higher than the 30 percent allowed under this safe harbor rule, then the taxpayer may make such higher allocation. The remaining portion of the research expenses are then apportioned based upon the SIC formula.

In the Economic Recovery Tax Act of 1981, Congress temporarily suspended the general source rules by providing that for the taxpayer's first two taxable years beginning after the date of enactment of the Act, all research and experimental expenditures (within the meaning of sec. 174) which are paid or incurred in those taxable years (and only in those taxable years) for research activities conducted in the United States shall be allocated or apportioned to sources within the United States for all purposes under the Code.

The Treasury Department is directed under the Act to conduct a study of the impact that the research expenditure allocation provisions of Treasury Reg. § 1.861–8 has on research activities conducted in the United States and on the availability of the foreign tax credit. The study, with recommendations to the Congress, is to be submitted by the Secretary of the Treasury to the House Committee on Ways and Means and the Senate Committee on Finance not later than six months after enactment of the Act.

Impact

Domestic research and experimental expenditures do not reduce foreign source income even though they generate that income. The foreign tax credit available to a company taking advantage of this provision is thus increased and a greater amount of foreign taxes can be credited against U.S. tax. As a result, for the first time since a limitation was added to the foreign tax credit, foreign taxes would be allowed to offset U.S. taxes imposed on U.S. source income. The provision will benefit those companies whose foreign tax burden is at or near the U.S. rate.

Rationale

The Congress believed that the portion of Treasury Reg. § 1.861–8 which relates to research expenses warrants further study because of its possible effect on U.S.-based research activities.

Taxpayers which are required to allocate research expenses for purposes of the foreign tax credit claim that more deductions must be allocated overseas than are allowed as deductions by the foreign country. Thus, taxpayers claim that their foreign tax credit limitation is lower than the foreign taxes paid and that they will lose foreign tax credits.

Because of the application of the regulation, taxpayers argue that they must transfer research activities to the foreign country

in order to obtain a deduction in that country and thus obtain a full foreign tax credit on the income earned in that country. The Congress believed that the transfer of research activities overseas would not be in the best interest of the United States. Therefore, the Congress has concluded that the Treasury should study the impact of the allocation of research expenses under Reg. § 1.861–8 on U.S.-based research activities.

While that study is being conducted by the Treasury and considered by the Congress, the Congress believes that the expenses related to all research activities conducted in the United States should be charged to the cost of generating U.S. source income, whether or not such research directly or indirectly is a cost of producing foreign source income.

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EXPENSING OF EXPLORATION AND DEVELOPMENT COSTS: OIL, GAS, AND OTHER FUELS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals		Corporations		Total	
	Oil and gas	Other fuels	Oil and gas	Other fuels	Oil and gas	Other fuels
1982	1,350		2,720	25	4,070	25
1983	1,470		3,060	30	4,530	30
1984	1,620		3,500	30	5,120	30
1985	1,850		3,875	35	5,725	35
1986	2,125		4,205	35	6,330	35
1987	2,385		4,635	40	7,020	40

Authorization

Sections 263(c), 465, 616–17, 704(d), and 1254 of the Internal Revenue Code of 1954, as most recently amended by section 402 of Public Law 95–618 (Energy Tax Act of 1978).

Description

Under standard accounting practices, the cost of acquiring or improving an asset designed to produce income over several years must be deducted only as the asset loses value. Taxpayers engaged in oil, gas, and geothermal energy production can, however, generally deduct the amount spent on "intangible drilling costs" in the year that the expenditure is made—they may "expense," rather than "capitalize" the qualifying expenses. Ninety-nine percent of the revenue lost through expensing of IDC's involves oil and gas exploration and development. The costs that are permitted this special treatment include the amount paid for fuel, labor, repairs, hauling, and supplies that are used in drilling oil, gas and geothermal wells, the costs of clearing ground in preparation for drilling, and the intangible (i.e., nonsalvageable) costs of constructing derricks, tanks, pipelines, and other structures and equipment necessary for drilling and preparing wells. Typically, these outlays comprise between 75 and 90 percent of total costs. By expensing rather than capitalizing these costs, taxes on income are effectively de-

ferred; it is as if an interest-free loan equal to the delayed tax liability were offered.

There are limits on this provision. Most notably, taxpayers can only expense the portion of their expenditures they actually have "at risk" (subject to loss) in the project. In addition, "recapture" rules apply if a taxpayer's interest in the project is sold, requiring that a portion of the gain be taxed as ordinary income rather than capital gains.

It is important to note that this provision does not apply to the cost of unsuccessful drilling or exploration. Even under normal accounting and tax rules the costs incurred in drilling a "dry hole" would be eligible for immediate deduction since no income-producing asset had been developed or improved.

Rationale

This tax expenditure was originally established through regulations issued in 1916, with the rationale that such "intangible" costs were ordinary operating expenses. In 1942 the Treasury recommended that the provisions be removed, but the Congress did not take action. Then, in 1945, a court decision invalidated the rules. In response, the Congress specifically built the provision into the 1954 tax law. Legislative history indicates that the justification for this provision was that it reduced uncertainty and therby stimulated additional mineral exploration.

The "at risk" and "recapture" restrictions that have since been placed on the use of the provision have primarily dealt with limiting the ability of high-income taxpayers to shelter their income from taxation through investment in mineral exploration.

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EXCESS OF PERCENTAGE OVER COST DEPLETION: OIL, GAS, AND OTHER FUELS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals		Corporations		Total	
	Oil and gas	Other fuels	Oil and gas	Other fuels	Oil and gas	Other fuels
1982	1,555	15	415	365	1,970	380
1983	1,305	15	390	410	1,695	425
1984	1,125	20	380	450	1,505	470
1985	1,255	20	470	495	1,725	515
1986	1,490	20	530	550	2,020	570
1987	1,540	25	550	615	2,090	640

Authorization

Sections 613 and 613A of the Internal Revenue Code of 1954, as most recently amended by section 403 of Public Law 95-618 (Energy Tax Act of 1978).

Description

Firms engaged in oil, gas, and other mineral extraction are permitted to deduct a "depletion" allowance against their income each year to reflect the physical and economic depletion of the mineral reserve as the mineral is recovered. There are two methods of calculating this deduction: cost depletion and percentage depletion. Cost depletion, following normal accounting practices, allows for the recovery of initial costs of discovering, purchasing, and developing a mineral reserve over the period during which the reserve produces income. Each year, the taxpayer can deduct a portion of his original cost equal to the fraction of the reserve which has been extracted. Strictly, the deduction equals the adjusted basis (the original cost minus previous deductions) times the ratio of the current year's production to estimated remaining recoverable reserves. Using this method, the cost recovered through depletion allowances cannot exceed the original cost of acquiring the reserve.

Under percentage depletion, a taxpayer deducts a fixed percentage of gross income from mining as a depletion allowance, regardless of the amount invested in the process. The deduction for gas

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and oil (27.5 percent from 1926 through 1969) is phasing down to 15 percent in 1984. Beginning in 1975 the percentage depletion allowance was repealed for major oil and gas companies. Those companies producing less than 50,000 barrels per day (independents) are exempted from repeal for 1,000 barrels of oil or its equivalent in gas, per day. In addition, regulated natural gas and gas sold under a fixed contract remains eligible for percentage depletion at a rate of 22 percent and geopressured methane gas is allowed a 10-percent depletion rate. Once transferred, proved reserves are not eligible for percentage depletion.

Percentage depletion may not exceed 50 percent of the net income from a particular property in any 1 year. This ceiling is known as the net income limitation. Moreover, independents face an additional cap of 65 percent of their taxable income (per taxpayer rather than per property). There is no limit, however, to the cumulative amount that can be deducted under percentage depletion.

Percentage depletion also applies to other minerals at rates currently ranging from 22 percent to 5 percent. Uranium qualifies for a 22-percent depletion allowance, coal for a 10-percent allowance, and oil shale for a 15-percent allowance. Geothermal deposits were permitted a 20-percent depletion allowance in 1981, but the rate is being scaled down to 15 percent for 1984 and thereafter. Nevertheless, close to 80 percent of the total fuels revenue loss is a result, in an average year, of oil and gas depletion.

The value of this expenditure to the taxpayer is the amount of tax savings that results from using the percentage depletion method instead of the cost depletion method.

Impact

Since the 1975 legislation repealed the percentage depletion allowance for most oil and gas production, only one-quarter of oil and gas production is estimated to be currently eligible for percentage depletion. Percentage depletion for other mineral deposits was unaffected by the 1975 legislation.

Percentage depletion has three types of effects. It (1) decreases the price of qualifying oil, gas, and other minerals and therefore encourages their consumption; (2) bids up the price of drilling and mining rights; and (3) encourages the development of new deposits and increases production. Which of these effects predominates depends upon who captures the largest share of the subsidy: consumers, landowners, or producers.

The reduction in the effective tax rate of mineral producers from the percentage depletion allowance is dependent on many factors, including the statutory percentage depletion rate and the effect of the net income limitation. In the past, the net income limitation kept the effective percentage depletion rate for coal at around 6 percent although the statutory rate is 10 percent. Because the rising price of imported oil has increased the average price of oil, coal has been substituted for oil, resulting in dramatic increases in the price of coal. The coal price increases will make the net income limitation inapplicable to much coal production, so the effective depletion rate is likely to rise to nearly the 10 percent statutory rate.

The combination of this subsidy and the deduction of intangible drilling costs represents a significant boon to mineral producers who are eligible for both. This capital cost recovery system for oil and gas can result in large negative effective tax rates for many producers. Three quarters of the original investment can be "written off" immediately, and then a portion of gross revenues can be written off for the life of the investment. It is possible for cumulative depletion allowances to total many times the amount of the original investment.

Rationale

Deductions in excess of depletion based on cost were first allowed in 1918 in the form of "discovery value depletion" which allowed depletion on the market value of the deposit after discovery rather than on its cost. The purpose was to stimulate exploration during war time and to relieve the tax burdens of small-scale producers. However, the Treasury believed that under this system taxpayers often established high discovery values, and thus claimed overstated depletion. In 1926, to avoid the administrative problems raised by the need to establish true market value, Congress substituted percentage depletion for oil and gas properties. Beginning in 1932, percentage depletion was extended to most other minerals.

In 1950, President Truman recommended the reduction of percentage depletion to a maximum of 15 percent, but Congress failed to take action on the recommendation. Only minor changes were made until 1969, when the depletion allowance for oil and gas was reduced from 27.5 percent to 22 percent, and "excess" depletion was made subject to the minimum tax starting in 1970. Substantial changes were made in the Tax Reduction Act of 1975 after the price of oil skyrocketed. Major oil and gas companies were excluded and the rate is being phased down to 15 percent for 1984 and thereafter.

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CAPITAL GAINS TREATMENT OF ROYALTIES FROM COAL

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	95	10	105
1983	80	15	95
1984	90	15	105
1985	105	15	120
1986	115	20	135
1987	130	20	150

Authorization

Sections 1231(b) and 631(c) of the Internal Revenue Code of 1954, as most recently amended by section 1402 of Public Law 94-455 (Tax Reform Act of 1976).

Description

Owners of coal mining rights who lease their property typically retain an economic interest in production through royalties on the mined coal. If the coal land is held for more than one year prior to disposition, the lessor may treat these royalties as capital gains rather than as ordinary income. In such cases, percentage depletion is not also available to the lessor.

Impact

The extent to which this provision results in tax savings—thereby encouraging leasing and subsidizing production—depends on how the benefits from capital gains treatment compare with those from percentage depletion.

In past years, percentage depletion on coal has often been large enough relative to profits to subject many corporations to the "net income limitation" which limits percentage depletion to 50 percent of net income. A depletion allowance equal to 50 percent of net income reduces a corporation's marginal tax rate to 23 percent (one-half of 46 percent), whereas capital gains treatment results in a 28 percent tax rate. However, if a taxpayer has a high basis for calculating cost depletion (which can be claimed as an offset to cap-

ital gains), the election of cost depletion together with capital gains treatment of royalties may result in a lower tax. Similarly, if the percentage depletion deduction is less than the net income limitation, capital gains treatment may be preferred.

For individuals, the capital gains treatment will usually yield higher tax savings than percentage depletion. Individuals may deduct 60 percent of the amount of any net capital gain from their gross income. The remaining 40 percent is subject to tax according to their normal rate. Thus, a taxpayer in the 50 percent tax bracket pays an effective tax rate on capital gains of 20 percent (.40 x .50).

In view of recently rising coal prices, the percentage depletion allowance will be less likely to reduce tax rates by the full 50 percent. The value of newly purchased coal deposits also will be likely to rise, which would increase the value of cost depletion. As a consequence, capital gains treatment will become relatively more valuable to both corporations and individuals. At the same time, the industry's need for these benefits will probably decline as increases in coal prices effectively encourage increases in coal production.

Rationale

Capital gains treatment of coal royalties was adopted in the Revenue Act of 1951. The legislative history suggests that it was adopted to: (1) extend the same treatment to coal lessors as that allowed to timber lessors; (2) provide benefits to long-term lessors with low royalty rates who were unlikely to benefit significantly from the percentage depletion deduction; and (3) encourage the leasing and production of coal.

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ALTERNATIVE FUEL PRODUCTION CREDIT

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982		95	95
1983		70	70
1984		70	70
1985		95	95
1986		140	140
1987		175	175

Authorization

Section 44D of the Internal Revenue Code of 1954 as amended by section 231 of Public Law 96-223 (Crude Oil Windfall Profit Tax Act of 1980). The credits expire December 31, 2000.

Description

The Windfall Profit Tax Act established a $3 per barrel of oil equivalent production credit for several forms of alternative fuel. With three delineated exceptions, however, the credit only takes effect if the price of oil falls to below $29.50 per barrel and phases in gradually until the price reaches $23.50. (Both the credit and the phase-in range are adjusted for inflation to 1979 levels.) Those not subject to this limit, and thus still eligible are: gas produced from Devonian shale, for which the credit is based on the price of deregulated natural gas rather than oil through 1982; processed wood fuels, which are eligible for three years after the production facility was placed in service, provided that it was placed in service in either 1980 or 1981; and steam produced from solid agricultural by-products, which qualify through 1985. The credit is offset by any benefits received from government grants, subsidized or tax-exempt financing, or energy investment credits.

Impact

With the limited exceptions noted above, the credit does not take effect until the price of oil drops below $29.50 per barrel in 1979 prices. If the price of oil should drop as much as some analysts predict over the next few years, the credit could have a substantial impact.

Rationale

As one part of a multi-faceted approach to meeting the nation's future energy needs, the Congress made a serious commitment to synthetic fuels production in 1980. Alongside the direct spending and loan programs established in the Energy Security Act (P.L. 96-294) and administered by the Synthetic Fuels Corporation, the Windfall Profit Tax legislation included these production credits.

The purpose of the credits is to reduce marketplace uncertainty (by absorbing some of the price fluctuations below a specified floor) and thereby ease access to capital. The Congress was aware that the price of oil would be too high for most of the credits by the time the legislation took effect and intended them to serve "only as protection for producers of alternative fuels against oil price reductions."

Further Comment

The production tax credit is but one of several federal subsidies and incentives established by the Congress for synthetic fuel production. A wide variety of programs may well be appropriate because of the variety of processes and problems within the industry. It can also be argued, however, that the direct grant approach is more efficient or that market forces make all such government subsidies and incentives unnecessary.

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ALCOHOL FUEL CREDIT

Estimated Revenue Loss [1]

[In milions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	5	15	20
1983	5	30	35
1984	5	30	35
1985	5	30	35
1986	5	30	35
1987	5	30	35

[1] In addition, the exemption from the excise tax for alcohol fuels results in a reduction in excise tax receipts of approximately $50 million annually for 1982 and 1983, and approximately $100 million annually thereafter.

Authorization

The alcohol fuel production credit is authorized in sections 44E and 86 of the Internal Revenue Code of 1954 as amended by sections 232 (b) and (c) of Public Law 96-223 (Windfall Profit Tax Act of 1980). It expires on December 31, 1992 and no carryforward may be made to a year beginning after 1994. The exemption from motor fuels excise taxes is authorized in section 4041 and 4081 of the Code as amended by section 221 of Public Law 95-618 (Energy Tax Act of 1978) and section 232(a) and (b)(3)(A) of the Windfall Profit Tax Act of 1980. The exemption remains in effect through December 31, 1992.

Description

The alcohol fuel excise tax exemption and the alcohol fuel tax credit work together to subsidize the production and use of alcohol fuels of a type suitable for use in an internal combustion engine. Since the exemption is the same for all fuels of at least 10 percent alcohol, the credit is needed to provide the same proportional benefits to producers of alcohol for mixed fuels that include more than 10 percent alcohol.

The Energy Tax Act of 1978 and the Windfall Profit Tax Act of 1980 exempt gasohol from the 4 cents per gallon federal excise tax on gasoline, diesel fuel, and other motor fuels, provided the gasohol is at least 10 percent alcohol. The exemption thus grants a 40 cents per gallon subsidy to alcohol producers. Alcohol produced from oil, natural gas, or coal does not qualify.

When the fuel is more than 10 percent alcohol, it qualifies for a tax credit (based on the volume and proof of alcohol it contains) as well as the excise tax exemption. However, the credit is reduced by the amount of excise tax exemption applicable to the fuel, thereby making the tax benefit on a per-gallon-of-alcohol basis the same for fuels which are 10 percent alcohol and fuels which are over 10 percent alcohol. The credit is 40 cents per gallon of alcohol of at least 190 proof and 30 cents per gallon of alcohol between 150 and 190 proof.

For example, if a taxpayer blends 7,000 gallons of gasoline and 3,000 gallons of 190 proof alcohol and sells the mixture to a service station, the amount of credit allowable would be $800, computed as follows: 3,000 gallons × $0.40 = $1,200, reduced by $400 (10,000 × $0.04).

If a blended mixture of alcohol and gasoline is sold for use as fuel in a trade or business, the producer qualifies for the credit. Where straight alcohol is used, on the other hand, the credit is available to the consumer, or, if sold at retail, to the seller. Any credits not used in the taxable year in which they are earned may be carried forward up to 7 years

Impact

Although alcohol fuels may become a major synthetic fuel source in the future, at present they are not competitive with gasoline. Alcohol fuel is not only higher in price; it also requires substantial energy to produce, thereby diminishing the net overall conservation effect. In addition, the production of alcohol fuel from corn and other feed grains increases the demand for these grains, leading to increases in price and the possibility of future shortages. The strategic value of quickly reducing petroleum consumption, however, may override these negative aspects.

Rationale

The credit was created to encourage production and use of alcohol fuels in order to extend the supply of liquid fuels and to reduce the reliance of the United States on imported petroleum. The Congress believed that the existing gasoline excise tax exemption did not give sufficient incentive for conversion to alcohol fuels. Along with the scheduled reduction or elimination of the excise taxes, the subsidy would cease to exist.

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EXCLUSION OF INTEREST ON STATE AND LOCAL GOVERNMENT INDUSTRIAL DEVELOPMENT BONDS FOR ENERGY PRODUCTION FACILITIES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982		5	5
1983	5	10	15
1984	5	15	20
1985	10	20	30
1986	15	30	45
1987	15	35	50

Authorization

Section 103 of the Internal Revenue Code of 1954 as amended by section 241–244 of Public Law 96–223 (Crude Oil Windfall Profit Tax Act of 1980).

Description

This tax expenditure is in fact three separate provisions, each extending the category of state- and local-government bonds eligible for federal tax exemption. The first, and largest in terms of lost revenue, exempts interest on an industrial development bond (IDB) which is used to finance a state- or local-government owned, independently operated, small-scale hydroelectric facility. The portion of the facility eligible for financing by tax-exempt IDBs declines from 100 percent at a facility of 25 megawatts or less to zero at the upper limit of 125 MWs. This provision includes an expiration date of January 1, 1986.

The Windfall Profit Tax Act also expanded the definition of solid waste disposal facilities. Newly eligible for tax-exempt status are steam generating plants where at least 50 percent of the fuel is solid waste or waste-derived (provided the derived fuel is produced at the same or adjacent facility), facilities produce alcohol for use as a fuel from solid waste or a derived feedstock, and other solid waste-energy plants.

Finally, interest on IDB's used to provide funding for certain state renewable energy programs was also made tax-exempt. The requirements are such that only the renewable energy source program in the State of Oregon qualified.

Impact

All three types of tax-exempt IDBs have been issued rarely and are thus very small revenue losers so far.

Rationale

Interest on IDB's for both the small-scale hydroelectric plants and the state-run renewable energy programs was made exempt in order to provide the same benefits to states and localities that other sections of the Windfall Profit Tax Act had provided in the form of credits to taxpayers. The Congress expanded the definition of eligible solid waste disposal facilities because the extant Treasury regulations were felt to deny tax-exempt financing to many of the most technologically efficient methods of converting waste into energy.

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RESIDENTIAL ENERGY CREDITS: SUPPLY INCENTIVES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	205		205
1983	260		260
1984	345		345
1985	500		500
1986	595		595
1987	35		35

Authorization

Section 44C of the Internal Revenue Code of 1954 as amended by section 101 of Public Law 95-618 (Energy Tax Act of 1978) and sections 201-203 of Public Law 96-223 (Crude Oil Windfall Profit Tax Act of 1980). The credits expire December 31, 1985, but they can be carried over for 2 years beyond this termination date.

Description

The first $10,000 of investment in residential renewable energy source equipment is eligible for a 40-percent tax credit. The $10,000 ceiling applies to cumulative expenditures over the entire period for which the credit is in effect. The credit is available to homeowners and renters.

"Renewable energy source equipment" is defined as equipment which transmits or uses solar, wind, or geothermal energy for heating and cooling or for providing hot water or electricity in a principal residence. Also eligible are expenditures for related labor costs and for the drilling of an onsite well for a geothermal deposit, provided that the deduction for intangible drilling costs has not been taken. Passive solar systems are ineligible for this credit since they constitute structural modifications.

The credit is not available for expenditures which are also financed by tax-exempt grants or federally subsidized energy financing.

Impact

Lack of information and seemingly long payback periods appear to be the most significant barriers to this type of investment. The credit shortened the time period required to recoup initial expenditures and the Congressional action helps to increase public awareness of these technologies. However, initial response to the credit was sluggish. As expected, almost all (96 percent) of the credit taken in 1978 went toward investments in solar heating and hot water systems. In 1980, Congress decided to increase the credit to strengthen its incentive. Enough data are not yet available to determine whether these credits have had an impact or whether higher energy prices alone are a sufficient incentive to encourage such investments.

In addition to the Federal conservation and solar tax credits, there are many State financial incentives. The most widely adopted measure is the exemption of solar systems from inclusion in the value of property for tax purposes. Several States have income tax deductions and more than 20 States provided an income tax credit ranging from 5 to 55 percent. Together with the 40 percent Federal credit (most State credits may be claimed on top of the Federal credit), these incentives may have considerable impact.

Rationale

The renewable energy source credits were enacted as part of the program to achieve self-sufficiency in energy production by reducing reliance on oil and gas. Although the fuel sources eligible for this credit were already economically practical, their commercialization has been slow. These technologies were particularly appealing because they were perceived to be less hazardous to the environment than coal or nuclear power. In order to give them a boost in the market and to enable them to compete with heavily subsidized conventional fuel sources, the Congress enacted a 30-percent investment credit in the 1978 Energy Tax Act. In 1980, this credit was increased to its present 40 percent.

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RESIDENTIAL ENERGY CREDITS: CONSERVATION INCENTIVES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	415		415
1983	410		410
1984	400		400
1985	400		400
1986	340		340
1987	10		10

Authorization

Section 44C of the Internal Revenue Code of 1954 as amended by section 101 of Public Law 95-618 (Energy Tax Act of 1978) and sections 201 and 203 of Public Law 96-223 (Crude Oil Windfall Profit Tax of 1980). The credits remain in effect through 1985.

Description

A 15-percent tax credit is available to homeowners and renters for certain purchases that increase the energy efficiency of their residences. The credit applies to the first $2,000 of qualifying expenditures on each principal residence over the entire period the credit is in effect. Therefore, there is a maximum cumulative credit of $300 for energy-saving expenditures made after April 9, 1977, and before January 1, 1986, provided the residence was substantially completed before April 20, 1977.

The following items are eligible for the credit: insulation, replacement burners and devices to modify flue openings to increase fuel efficiency, electrical or mechanical furnace ignition systems that replace gas pilot lights, storm or thermal windows or doors, automatic setback thermostats, caulking or weatherstripping, and energy usage meters. The Secretary of the Treasury is empowered to add to the list under the conditions that: (1) the new equipment or technology would result in a reduction in oil or natural gas large enough to justify the expenditures; (2) the new equipment or technology would not increase the use of environmentally hazardous or otherwise unsafe items; and (3) the addition to the list would

not be unnecessary or inappropriate because of existing Federal subsidies. No additions have yet been made.

To prevent "double dipping" from both tax benefits and direct outlays, the credit is not available insofar as the energy conserving expenditure was paid for by tax-exempt grants or other subsidized energy financing.

Rationale

Considerable energy savings can be achieved in the residential sector through the application of existing methods, such as insulation. The Congress perceived that there were barriers to the installation of such items; the long length of time necessary to recoup the original investment was one of the most prominent. To reduce this and other obstacles to increased conservation efforts among existing homes, the Congress instituted this credit. The Congress, after the 1979 energy price increases, expanded the credit, perceiving that although higher prices made these investments more economical, there was a continued need to speed the rate at which the investments were made.

Impact

The tax credit was designed primarily to encourage homeowners to improve the energy efficiency of their residences. The then current rises in energy prices and the growing expectation that they would likely remain high may have obviated much of the need for the subsidy. The current provision may, therefore, be largely providing a windfall for purchases of conservation equipment that would have been made anyway, rather than adding to the total amount or speeding the rate of investment.

Substantial evidence suggests that the largest remaining residential conservation gains are to be had among low-income households. At least 43 percent of such households have no insulation and 58 percent have no storm windows or doors, compared to 17 percent and 39 percent for all households. The credit does not provide an effective subsidy for these households for a variety of reasons: most of them are renters, and the credit is unavailable to landlords; many low-income renters do not have sufficient disposable income to allow them to invest the 85 percent of the cost of insulation not covered by the credit; and, the credit is not refundable.

In addition to the question of appropriate targeting, there are also concerns about the administrative feasibility of the credit. The information needed to determine eligibility for the credit is not normally available on tax returns and the IRS has no easy way of checking whether energy-saving items were actually installed, whether they were of the eligible type, whether they cost as much as the taxpayer claimed, and so on. Abuse of this provision may thus be a problem.

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ALTERNATIVE, CONSERVATION AND NEW TECHNOLOGY CREDITS: SUPPLY INCENTIVES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	20	180	200
1983	25	295	320
1984	30	460	490
1985	30	610	640
1986	30	510	540
1987	20	475	495

Authorization

Sections 46 and 48 of the Internal Revenue Code of 1954 as amended by sections 241 and 301(a)–(c) of Public Law 95–618 (Energy Tax Act of 1978) and sections 221 and 222 of Public Law 96–223 (Crude Oil Windfall Profit Tax Act of 1980). The credits established in the 1978 act were to expire on January 1, 1983. In several instances, however, the Windfall Profit Tax Act extended the expiration date to December 31, 1985.

Description

The Energy Tax Act and the Windfall Profit Tax Act include investment tax credits for equipment using alternate sources of energy. Alternative energy is defined as any energy source other than oil, natural gas, or their products (with the exception of petroleum coke and petroleum pitch). The legislation provides a 10 percent, nonrefundable energy investment credit for technology used to burn alternative substances (including biomass) or convert them to synthetic fuel and for equipment used to extract oil from shale rock and natural gas from geopressured brine. The credit may be used against 100 percent of income tax liability.

In addition, the Windfall Profit Tax Act provides a 15-percent, nonrefundable credit for investments in: solar and wind energy equipment used to generate electricity or to provide heating, cooling, hot water or process heat, and technology to produce, distribute, or use geothermal or ocean thermal energy. These credits extend through 1985.

Finally, the 1980 act establishes an 11 percent-tax credit for investments in small-scale (capacity less than 125 megawatts) hydroelectric generating facilities. In this case, the fraction of the investment eligible for the credit declines as the generating capacity increases. For example, 100 percent of the investment qualifies for the credit when the capacity is 25 megawatts or less, while only 25 percent qualifies at 100 megawatts. At 125 megawatts the credit is phased out entirely. This provision remains in effect until December 31, 1985, but there is an extension to December 31, 1988 for qualifying investments for which an application has been received before January 1, 1986.

Impact

As with the energy-conservation business tax credits, it is not clear how much these credits encourage additional investment as opposed to subsidizing investment that would have been made anyway. Generally, the need for the tax credits is likely to decline over time as investors' uncertainty about the new technologies is dispelled.

Rationale

The rationale behind the introduction of these credits was primarily to reduce the dependency of the United States on oil and natural gas. In this instance, the strategy was to encourage the use and production of alternative fuels.

The relatively high levels of expense and uncertainty associated with these technologies and various institutional barriers to these investments, combined with the divergence of social benefits from private benefits, prompted the Congress to provide these tax credits as incentives. Due to the sluggish initial response, the credits for renewable energy sources were expanded and extended in the Windfall Profit Tax Act.

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ALTERNATIVE, CONSERVATION AND NEW TECHNOLOGY CREDITS: CONSERVATION INCENTIVES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982		315	315
1983		280	280
1984		180	180
1985		55	55
1986		25	25
1987		10	10

Authorization

Sections 46 and 48 of the Internal Revenue Code of 1954 as amended by sections 241 and 301(a)-(c) of Public Law 95-618 (Energy Tax Act of 1978) and sections 221 and 222 of Public Law 96-223 (Crude Oil Windfall Profit Tax Act of 1980). The credits are all due to expire on December 31, 1982. Where "affirmative commitments" have been made, however, some may be extended through 1990.

Description

Investments in "specially defined energy property" that increase the energy efficiency of commercial or industrial facilities and processes are eligible for a 10-percent nonrefundable business energy investment credit. Where tax-exempt industrial developments bonds are used in the financing, the credit is 5 percent. The energy tax credit may be taken on new equipment that has a useful life of 3 years and it may be applied against 100 percent of income tax liability, but it may not exceed the recipient's tax liability.

The Energy Tax Act of 1978 defined as eligible the following equipment: (1) a recuperator, (2) a heat wheel, (3) a regenerator, (4) a heat control system, (5) a waste heat boiler, (6) a heat pipe, (7) an automatic energy control system, (8) a turbulator, (9) a preheater, (10) a combustible gas recovery system, (11) an economizer, and (12) recycling equipment. Most of these reduce energy consumption

through the recovery and utilization of waste heat. The Windfall Profit Tax Act of 1980 expanded the list to include energy-saving modifications made to alumina electrolytic cells and cogeneration equipment where no more than 20 percent of the fuel consumed in the process is oil or natural gas (or their derivatives). It is important to note that while several of these technologies can be used for purposes such as space heating of large buildings, the credit only applies when they are directly integrated into an industrial or commercial process, narrowly defined. Although the Treasury has the statutory power to expand this list further, it has not done so.

The 1980 act extended the expiration date of these credits from December 31, 1982 to December 31, 1990, in those instances where all engineering studies have been completed and all environmental and construction permits have been applied for before January 1, 1983, and where the taxpayer has entered into binding contracts to acquire and/or construct at least 50 percent of the total estimated value of the project before January 1, 1986.

Impact

The business energy investment credit is aimed at promoting energy conservation by reducing the price of energy-conserving capital to business investors. While the credit provides added, and perhaps sometimes decisive, encouragement to businesses considering such investment, higher energy prices and other market conditions probably provide the primary incentive. It is unclear to what degree the credit encourages additional investment or merely provides "windfall subsidies" to firms that would have made these investments anyway. It is also possible that in some cases, the credit may be absorbed in part by increases in equipment prices that are induced by the credit.

For the most part, the energy investment credit has been claimed by large corporations. These firms use the bulk of the energy and therefore have a greater incentive to adopt energy-efficient measures.

Rationale

The 1973 Arab oil embargo revealed the degree to which the United States was dependent on foreign energy and the vulnerability of the domestic economy to external price shocks. The Congress decided that a decrease in domestic energy demand and an increase in domestic energy supply were required both to insure economic stability and the independence of our foreign policy.

Although higher prices could be expected to bring these two things about, the full extent of future price increases as well as the decision to decontrol were not yet known at the time of enactment. The Congress therefore decided to stimulate conservation directly.

The energy tax credits were aimed at lowering barriers to investment in conservation equipment. Energy-conserving technologies are often more expensive and their future performance may appear uncertain to the potential investor. In addition, the absence of adequate information regarding appropriate technologies inflates the perceived risk and further discounts future benefits. Another barrier is created when firms defer such investments because they be-

lieve that opportunities for investment in energy efficiency are always present, while opportunities for achieving other goals may not be.

Congress also recognized the existence of externalities. When the national security impact is taken into account, the payback to society as a whole is greater than the payback to investors, and the level of investment may therefore be less than socially optimal.

In 1980, the Congress reviewed the energy investment tax credit and determined that is was too narrowly defined. Several forms of energy property were made newly eligible and the termination date of the credit was extended for certain projects in order to encourage investment more effectively.

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ENERGY CREDIT FOR INTERCITY BUSES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982		5	5
1983		5	5
1984		5	5
1985		5	5
1986			
1987			

Authorization

Sections 46 and 48 of the Internal Revenue Code of 1954 as amended by sections 221 and 223 of Public Law 96-223 (Crude Oil Windfall Profit Tax Act of 1980). The credit expires on December 31, 1985.

Description

A 10-percent energy investment credit is available for investments in passenger and charter buses used for intercity transport usage. The credit only applies to investments which increase a fleet's operating seat capacity over the levels of the previous year. To qualify for the credit, new additions to a fleet must have seating for at least 35 passengers (not including the driver) and one or more baggage compartments of at least 200 cubic feet.

Impact

The impact of this credit is uncertain for several reasons. First, it is possible that the subsidy may be absorbed by producers rather than purchasers of the buses, thus increasing the price rather than the number of buses supplied. Second, it is not clear whether the credit has encouraged investment above the level that would have been achieved otherwise. Third, even additional investment may not necessarily lead to energy efficiency if the buses are not operated at high capacities.

This energy investment tax credit was enacted in addition to the exemption from excise tax for buses, bus parts, and certain related items included in the 1978 Energy Tax Act. Both measures may be

necessary to provide sufficient incentive, or they may be redundant.

Rationale

Intercity buses can be the most energy efficient mode of intercity transportation. Operating at 50 percent capacity, buses require considerably less than one-half the energy (in Btus) per passenger mile needed by automobiles or Amtrak and less than one-fourth the amount needed by airplanes. For this reason, the Congress established this 10-percent tax credit as a part of the effort to encourage energy conservation.

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EXPENSING OF EXPLORATION AND DEVELOPMENT COSTS, NONFUEL MINERALS

Estimated Revenue Loss

[In milions of dollars]

Fiscal year	Individuals	Corporations	Total
1982		50	50
1983		55	55
1984		60	60
1985		65	65
1986		75	75
1987		80	80

Authorization

Sections 263(c), 465, 616-617, 704(d), and 1254.

Description

Taxpayers engaged in mining activities may deduct exploration and development costs as incurred (i.e., these costs may be "expensed").

Mining exploration costs are expenditures for the purpose of ascertaining the existence, location, extent or quality of any deposit of ore or other depletable mineral paid or incurred by the taxpayer prior to the development stage of the mine or deposit. For example, exploration expenditures include amounts paid or incurred to ascertain the existence of a commercially marketable ore deposit. Foreign exploration costs cannot be expensed after the taxpayer has total foreign and domestic exploration costs of $400,000.

Development expenses generally include those incurred for the development of a mine or other natural deposits after the existence of ores in commercially marketable quantities has been determined. Development expenditures generally include those for construction of shafts and tunnels, and in some cases drilling and testing to obtain additional information for planning operations. There are no limits on the current deductibility of such costs. Mine development costs may be taken in addition to percentage depletion. Mining exploration costs subsequently reduce percentage depletion deductions. In the case of mines, there are "recapture" provisions under which capital gains from the sale of the property are treated

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as ordinary income to the extent of prior deductions for exploration expenses.

Impact

Generally, expenditures that generate assets yielding income over several years must be capitalized and deducted over the period in which the assets produce income. The tax advantage of treating these expenditures as current expenses is the same as any other use of premature deductions; the taxpayer is allowed to defer current tax liabilities; this treatment amounts to an interest-free loan from the Treasury.

These expensing provisions are additional benefits which supplement the special percentage depletion allowances extended to the mineral industry. Although the expensing and depletion provision operate somewhat independently, a firm or person may be eligible for both and receive their combined benefits.

Rationale

Expensing of mine development expenditures was enacted in 1951 to reduce ambiguity in the then existing treatment of and to encourage mining. The provision for mine exploration was added in 1966.

Prior to the Tax Reform Act of 1969, a taxpayer could elect either to deduct without dollar limitation exploration expenditures in the United States, which subsequently reduced percentage depletion benefits, or to deduct up to $100,000 a year with a total not to exceed $400,000 of foreign and domestic exploration expenditures without the application of the recapture rule. The 1969 act subjected all post-1969 exploration expenditures to recapture.

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EXCESS OF PERCENTAGE OVER COST DEPLETION, NONFUEL MATERIALS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	15	390	405
1983	15	425	440
1984	20	450	470
1985	20	480	500
1986	25	515	540
1987	25	550	575

Authorization

Sections 613 and 613A.

Description

Most firms engaged in mineral extraction are permitted to deduct a depletion allowance for the exhaustion of the mineral deposits. There are two methods of calculating depletion: percentage depletion and cost depletion. Taxpayers who qualify for percentage depletion must use it if it is greater than cost depletion.

Under percentage depletion, a taxpayer deducts a fixed percentage of gross income from mining as a depletion allowance, regardless of the amount invested in the deposit.

Percentage depletion applies to mineral resources at percentages currently ranging from 22 percent to 5 percent. Sulphur, uranium, and most other metals mined in the United States qualify for the 22 percent rate; however, domestic gold, silver, and iron ore qualify for a 15-percent rate; most minerals mined outside the U.S. qualify for a 14-percent rate; coal qualifies for a 10-percent rate; and several forms of clay, gravel, and stone qualify for 5- and 7½-percent rates.

Percentage depletion may not exceed 50 percent of the net income from the property. This limitation is known as the net income limitation. The total cost which can be recovered by percentage depletion is *not* limited to the cost of the property.

Cost depletion resembles depreciation based upon the number of units produced. The share of the original cost deduction each year is equal to the portion of the estimated total production (over the

life-time of the well or mine) which is produced in that year. Using cost depletion, capital recovery cannot exceed the initial cost.

The value of the percentage depletion provision to the taxpayer is the amount of tax savings on the excess of the percentage depletion over cost depletion.

Impact

Issues of principal concern are the extent to which percentage depletion: (1) decreases the price of qualifying minerals, and therefore encourages their consumption; (2) bids up the price of exploration and mining rights; and (3) encourages the development of new deposits and increases production.

Most analyses of percentage depletion have focused on the oil and gas industry, which prior to 1975 accounted for the bulk of percentage depletion.

Because of the prior focus on oil and gas percentage depletion, there has been relatively little analysis of the impact of percentage depletion on other industries. The relative value of the percentage depletion allowance in reducing the effective tax rate of mineral producers is dependent on a number of factors, including the statutory percentage depletion rate and the effect of the net income limitation.

Rationale

Deductions in excess of depletion based on cost were first allowed in 1918 in the form of "discovery value depletion" which allowed depletion on the market value of the deposit after discovery rather than on its cost. The purpose was to stimulate exploration during wartime and to relieve the tax burdens on small-scale prospectors. However, the Treasury believed that under this system taxpayers often established high discovery values, and thus claimed excessive depletion. In 1926, to avoid the administrative problems raised by the need to establish market value, Congress substituted percentage depletion for oil and gas properties. Beginning in 1932, percentage depletion was extended to most other minerals.

In 1950, President Truman recommended the reduction of percentage depletion to a maximum of 15 percent, but Congress failed to take action on this recommendation. Only minor changes were made until 1969, when the deletion allowance for oil and gas was reduced from 27.5 percent to 22 percent, and "excess" depletion was made subject to the tax on preferences beginning in 1970.

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CAPITAL GAINS TREATMENT OF CERTAIN TIMBER INCOME

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	140	460	600
1983	115	500	615
1984	110	535	645
1985	125	585	710
1986	135	635	770
1987	145	680	825

Authorization

Sections 631 (a) and (b), 1221 and 1231.

Description

If a taxpayer has held standing timber or the right to cut it for more than 1 year, the taxpayer may elect to treat the cutting of this timber as the sale of a long-term capital asset at a price equal to its fair market value on the first day of the taxable year. If an election is made, gain or loss accruing before the first day of the year in which the cutting occurs is treated as long-term capital gain or loss. Changes in the value of the timber after the first of the year result in ordinary income or loss, and not capital gain or loss. Capital gains treatment also can apply to the sale of a stand of timber and the sale of timber as it is cut by the buyer. Timber includes ornamental evergreens that are 6 years of age of more when severed from the roots.

Impact

The capital gains treatment of the cutting and sale of timber constitutes a departure from the general rule that sale of a taxapayer's inventory yields ordinary income. However, when timber is inventory, it is usually held substantially longer than other types of inventory.

Both individual and corporate taxpayers are eligible for this treatment. The graduated structure of the individual income tax rates makes the provision more beneficial to individuals with high incomes because the value of the deduction for capital gains increases with the marginal income tax rate.

Two industries—paper and allied products and lumber and wood products—claim disproportionately large amounts of corporate cap-

ital gains. According to 1977 Statistics of Income for Corporations, 23 percent of taxable income of paper and allied products industries and 50 percent of taxable income of lumber and wood products were long-term capital gains. This proportion may be contrasted with a proportion of 4.8 percent for all other corporations. These two industries reported 16.7 percent of all corporate capital gains while accounting for only 2.6 percent of taxable income. Treasury Department studies published in 1969 indicated that in these industries 5 corporations accounted for about one-half of the capital gains claimed, 16 firms accounted for about two-thirds, and 80 percent of the gains were accounted for by approximately 60 corporations.

Some of a timber owner's costs which maintain or even arguably improve his trees, such as disease control and thinning costs, can be expensed currently (see appendix B), even though their effects may continue beyond the year in which they are made, and though they are related to income which only will be recognized many years in the future. Therefore, timber ownership offers opportunities for some taxpayers to deduct current expenses associated with such ownership against ordinary income from other sources.

Rationale

The sale of a timber stand that had not been held in the course of business was long considered the sale of a capital asset. The Revenue Act of 1943 extends this capital gain treatment to all persons who cut and sell their timber and to those who lease timber stands for cutting. One reason for adopting this provision was to equalize treatment between the taxpayer who sold timber as a stand outright, and the taxpayer who cut timber for use in his business. It was also suggested that this treatment would encourage conservation of timber through selective cutting and that taxing the capital gain at ordinary rates was an unfair practice because of the comparatively long development time of timber.

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INVESTMENT CREDIT AND SEVEN-YEAR AMORTIZATION FOR REFORESTATION EXPENDITURES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	5		5
1983	5		5
1984	10		10
1985	10		10
1986	10		10
1987	10		10

Authorization

Section 48; section 194.

Description

A taxpayer may elect to amortize, over a 7-year period, up to $10,000 of qualifying reforestation expenditures incurred during a taxable year in connection with the commercial production of timber. Qualifying expenditures are the direct costs incurred to plant or seed for forestation or reforestation purposes, including costs for site preparation, seed or seedlings, and labor and tool costs (including depreciation on equipment used for this purpose). Costs for which the taxpayer has been reimbursed under a governmental cost-sharing program are generally excluded. Costs which are currently deductible are excluded. The amortization deductions are taken in computing adjusted gross income. Costs in excess of $10,000 in any taxable year may not be carried over to succeeding years. A mandatory half-year convention is provided.

The 10-percent investment tax credit is allowed for reforestation costs eligible for the amortization election, regardless of whether amortization treatment is elected. The same annual limitation applies, and there is no carryover of excess qualifying costs. The investment credit under these provisions may not be claimed for qualifying reforestation expenditures that otherwise qualify for the credit (as, for example, depreciation on equipment used for reforestation that already qualifies for the regular investment credit).

Impact

Under prior law, reforestation costs were treated as capital expenditures, to be recovered when the timber was harvested. Such expenditures did not qualify for the investment tax credit. The provision thus extends to reforestation expenditures a special treatment that departs from the general requirement of matching expenditures and income and the distinction between investment and capitalized expenditures.

Rationale

The reason for the provision, as stated by the conference committee, is to promote reforestation on private timberlands.

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CAPITAL GAINS TREATMENT OF IRON ORE

Estimated Revenue Loss

[in million of dollars]

Fiscal year	Individuals	Corporations	Total
1982	10	10	20
1983	10	10	20
1984	10	10	20
1985	10	10	20
1986	10	10	20
1987	10	10	20

Authorization

Sections 631(c) and 1231(b)..

Description

Owners of economic interests in domestic iron ore deposits which have been held more than 1 year prior to disposition, including lessors but not including any person who is a principal in the mining of iron, who disposes of the iron ore by any form of contract in which he retains an economic interest in the iron ore disposed of, must treat the difference between the depletion basis and amount realized, including royalties, as capital gains rather than as ordinary income. Percentage depletion is not available in such cases.

This provision cannot be used by taxpayers obtaining iron ore royalties from related individuals or corporations.

Impact

The extent to which this provision results in tax saving depends on how the benefits compare with those from percentage depletion. In past years, percentage depletion on coal often has been large enough relative to profits to subject many firms to the "net income limitation" which limits percentage depletion to 50 percent of net income. In contrast, this apparently has not been the case for iron ore where the percentage depletion deduction is less likely to be subject to the net income limitation.

For corporations, a percentage depletion deduction equal to 50 percent of net income reduces the marginal tax rate to 23 percent (one-half of 46 percent), whereas capital gains treatment results in a 28-percent tax rate. However, if the mine has a high basis for cal-

culating cost depletion (which can be claimed ratably as an offset to capital gains), the election of this provision may result in a lower tax. Similarly, if the percentage depletion deduction is less than the net income limitation, capital gains treatment may be preferred.

For individuals, the tax reduction from the capital gains deduction (60 percent) will exceed the maximum deduction available for the percentage depletion when the net income limitation is applicable. In general, therefore, capital gains treatment will be more favorable to individuals than percentage depletion.

The tax expenditure associated with this provision is the incremental reduction in overall tax liability available to taxpayers able to avail themselves to capital gains treatment and cost depletion over what their tax liability would have been had they been restricted to ordinary income treatment and percentage depletion.

Rationale

Capital gains treatment for coal royalities was adopted in the Revenue Act of 1951. The legislative history suggests it was adopted to: (1) extend the same treatment to coal lessors as that allowed to timber lessors; (2) provide benefits to long-term lessors with low royalty rates who were unlikely to benefit significantly from the percentage depletion deduction; and (3) encourage the leasing and production of coal.

Capital gains treatment of iron ore royalties was added in the Revenue Act of 1964 to make the treatment of iron ore generally consistent with coal, and to encourage leasing and production of iron ore deposits in response to foreign completion.

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EXCLUSION OF INTEREST ON STATE AND LOCAL GOVERNMENT POLLUTION CONTROL BONDS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	275	565	840
1983	320	655	975
1984	365	740	1,105
1985	405	820	1,225
1986	445	900	1,345
1987	485	975	1,460

Authorization

Section 103(b)(4)(F).

Description

The interest on industrial development bonds (IDB's) used to finance the construction or purchase of air and water pollution control facilities is excludable from gross income. (For a description of industrial development bonds generally, (see the section in function 370 on the Exclusion of Interest on State and Local Industrial Development Bonds.)

As in the case of other industrial development bonds, a State or local government issues pollution control bonds that are backed by the rents received from facilities built with the bond proceeds. The proceeds are used to construct or purchase pollution control equipment that is leased to a private firm. The firm then guarantees payment of the bonds. Interest on the bonds is tax exempt because in form, but not in substance, the bonds are a debt of a State or local government.

Impact

Tax-exempt pollution control bonds subsidize the cost of complying with antipollution regulations. Because the interest is tax exempt, the issuer can attract bond purchasers with lower interest rates than the lessee of the pollution control equipment would pay if it issued taxable bonds. In this manner, the exclusion from gross

income of the interest reduces the interest costs of private pollution control equipment.

Principal users of pollution control bonds are electric utilities, metal producers and processors, oil companies, chemical companies, and paper companies. Most pollution control bond issues are made to finance pollution control equipment for large firms.

Reported pollution control bond sales rose from an estimated $93 million in 1971 to $3.9 billion in 1981. This represented 7 percent of total long-term municipal debt. Pollution control bond issues are projected to grow at roughly 15 percent a year in the next few years.

The growth in the use of pollution control and other industrial development bonds has exerted strong pressure on all tax-exempt interest rates, reduced the attractiveness of tax-exempt issues generally relative to taxable issues, and diluted the effectiveness of the exclusion.

Critics claim further that, as with the exclusion of interest on all State and local debt, some of this foregone revenue flows into investors' pockets without reducing actual borrowing costs. For example, it is estimated that every $0.75 of interest saved by State and municipal governments because the interest on their bonds is not taxable, costs the Treasury $1.00 of revenue foregone.

The purchasers of pollution control bonds are both institutional and individual investors. The market for the bonds is much the same as that for other IDB's. (See the section in function 370 on the Exclusion of Interest on State and Local Industrial Development Bonds.)

Rationale

The Congress lifted the constraints on tax-exempt pollution control bonds in the Tax Reform Act of 1969 in anticipation of the passage of antipollution regulatory legislation. Since the projected costs of compliance were considered high, the Congress created a vehicle through which the Federal Government would share these costs with the private sector.

Further Comment

As with other tax-exempt municipal debt, the proliferation of pollution control bonds has elicited suggestions for alternative subsidies to pollution control facilities. These include subsidized taxable bonds and alternative tax incentives, such as special investment tax credits and immediate deduction of the cost of pollution control equipment. The Treasury Department has recently proposed restrictions on the use of IDB's that would limit the use of tax-exempt pollution control bonds. (For a more detailed discussion, (see the section in function 370 on the Exclusion of Interest on State and Local Industrial Development Bonds.)

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EXCLUSION OF PAYMENTS IN AID OF CONSTRUCTION OF WATER, SEWAGE, GAS, AND ELECTRIC UTILITIES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982		30	30
1983		45	45
1984		70	70
1985		75	75
1986		80	80
1987		75	75

Authorization

Sections 118(b) and 362(c).

Description

"Contributions in aid of construction" to water and sewage disposal utilities are not included in the utilities' gross income if the contributions are spent for the construction of certain facilities within 2 years after receipt of the contributions. This treatment is extended only to regulated utilities that provide steam, electric energy, gas (through a local distribution system or transportation by pipeline), water or sewage disposal services to the general public in their service areas. In general, a qualifying contribution in aid of construction is made by a builder-developer, either as funds paid to a qualifying utility which uses them to build public utility facilities, or else as completed facilities transferred to the utility. Customer connection fees do not qualify as nontaxable capital contributions. These connection fees include payments made by customers for the cost of installing connections between their property and a utility's main distribution or disposal line.

Qualifying contributions may not be included in the rate base for ratemaking purposes by the regulatory body having ratemaking jurisdiction. No depreciation may be claimed and no investment credit may be taken with respect to any property acquired as the result of a qualified expenditure.

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Impact

If contributions in aid of construction were taxable currently, utilities would: (1) pay tax on the contributions; (2) claim the investment credit on facilities constructed with the qualify contributions; and (3) depreciate the facilites over their appropriate useful lives. Thus, if contributions were currently taxable, over time, utilities would recover the resulting tax payments through depreciation deductions. In effect, compared to the treatment of contributions in aid of construction as taxable income, the treatment as non-taxable contributions under sections 118(b) and 362(c) constitutes a tax deferral rather than an exclusion.

Since amounts collected as contributions to capital are not included in a utility's rate base, they cannot result in increased rates to consumers or increased utility gross income. Absent the exclusion, the costs of water or sewage disposal contributions in aid of construction probably would be passed on by a utility to the developers and builders who receive services directly related to these contributions. In turn, the developers and builders would pass on part or all of the costs to their customers.

Rationale

Prior to 1958, all public utilities had been permitted to exclude from gross income currently the contributions they had received in aid of construction of facilities. In 1958, under Rev. Rul. 58–555, the IRS limited this favorable treatment to regulated utilities.

However, in 1975, in Rev. Rul. 75–557, the IRS held that amounts paid by a home purchaser as a connection fee to obtain water service were includable currently in a utility's income.

For many regulated utilities, the issuance of Rev. Rul. 75–557 had no tax effect as far as connection fees were concerned because these fees had historically been included in gross income. The problem, however, was that Rev. Rul. 75–557 might have been construed by the IRS as applying to more than just connection fees, and might have subjected to tax for the first time contributions in aid of construction, which previously had been excluded as nonshareholder contributions to capital. It was unclear under the relevant case law whether various types of contributions in aid of construction constituted taxable income. The present statute was originally enacted in 1976 to clarify the exclusion for regulated water and sewage utilities, subject to the limitations described above. In 1978, these provisions were extended to contributions made to regulated public gas, electric, and steam utilities.

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TAX INCENTIVES FOR PRESERVATION OF HISTORIC STRUCTURES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	80	55	135
1983	100	70	170
1984	125	85	210
1985	145	95	240
1986	165	110	275
1987	190	130	320

Authorization

Sections 48(g) and 280B.

Description

Owners of historic buildings are encouraged to renovate them by a 25-percent tax credit available for amounts spent on substantial rehabilitations approved by the Department of the Interior. Owners are restricted to a straight-line recovery method for these expenditures, but can recover them over the usual 15-year period. Part of the credit is recaptured if the property is sold within the first 5 years. The credit, enacted in 1981, applies to expenditures made after January 1, 1982, and replaces provisions enacted in 1976 that allowed owners of historic structures either to amortize rehabilitation expenditures over a 5-year period or to use a depreciation method normally allowed only for new structures. Since 1976, owners who demolish historic buildings have not been allowed to deduct demolition costs in the year of demolition but must add them to the cost of the land, or in some cases to the cost of the building to be written off over 15 years.

Example

A taxpayer who buys a dilapidated historic building for $300,000 and spends another $800,000 on renovation is entitled in the first year to a tax credit of $200,000 ($800,000 × 0.25). In addition, aside from the land component, the full $1.1 million ($300,00 + $800,000) can be recovered over a 15-year period.

Impact

Between 700,000 and 1,000,000 buildings now could qualify for the credit (subject to approval of the Department of the Interior), although only about 30 percent of them are currently income-producing. From 1977, when tax incentives for historic preservation first became available, until 1981, about 3,500 project applications were received by the Interior Department, with total rehabilitation expenditures estimated at $1.6 billion. A big increase in applications is expected because the tax incentives were made so much more lucrative for 1982. The Interior Department expects to receive about 2,000 applications in 1982, with each project costing $500,000 on average.

Rationale

The tax provisions adopted in 1976 were meant to further the goal of rehabilitating and preserving historic structures and neighborhoods. Achievement of this goal was thought to be dependent upon the enlistment of private funds in the preservation movement. The Congress believed tax considerations play an important role in determining whether private interests will maintain and rehabilitate historic structures. Partly as a move toward simplification, the tax incentives were changed to a tax credit in 1981 and made part of a three-tier investment tax credit for rehabilitating older buildings.

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EXPENSING OF CERTAIN CAPITAL OUTLAYS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	460	85	545
1983	475	85	560
1984	495	90	585
1985	510	95	605
1986	530	100	630
1987	545	100	645

Authorization

Sections 162, 175, 180, 182, 278, 447, 464, 465, and 704(d), Regulations 1.61–4, 1.162–12, and 1.471–6.

Description

Certain farm businesses, generally individuals and family-owned corporations, may use the cash method of tax accounting to deduct costs attributable to goods held for sale and in inventory at the end of the tax year. These businesses also are allowed to expense (i.e., deduct as they are incurred) some costs of developing assets that will produce income in future years. Both of these rules deviate from generally applicable tax accounting rules, which do not permit deduction of inventory costs until the inventory is sold, and which require the cost of income-producing assets to be deducted over their useful lives. These rules thus allow deductions to be claimed before the income associated with the deductions is realized.

Items that may be deducted before income from them is realized include cattle feed, expenses of planting crops for the succeeding year's harvest, and development costs such as those incurred in planting vineyards and fruit orchards. There are special rules that require outlays for developing young citrus and almond groves to be capitalized.

Certain costs that otherwise would be considered capital expenditures may be deducted immediately by all farmers pursuant to specific sections of the Internal Revenue Code. These costs include expenses for soil and water conservation (sec. 175), land clearing (sec. 182), and fertilizer (sec. 180).

Certain restrictions primarily aimed at tax shelters apply to farming deductions. Farm syndicates are restricted in their deductions of preproduction expenses, and farm loss deductions allowable to individual taxpayers are restricted to amounts "at risk," or actually invested, in a farming venture.

Impact

The effect of deducting costs before the associated income is realized is the understatement of income in the year of deduction followed by an overstatement when the income is realized. The net result is that tax liability is deferred from the time the deduction is taken to the asset's productive period. This affords the taxpayer an interest-free loan in the amount of the deferred tax. When the income is finally taxed, it may be taxed at preferential capital gains rates.

The expensing of capital outlays provides a general incentive for farming investments that qualify for this treatment, and particularly favors farming investments with long development periods (such as orchards and vineyards).

Rationale

The special rules with respect to development costs and cash accounting were established in regulations issued very early in the development of the tax law. At that time, because accounting methods were less sophisticated, tax rates were low, and the typical farming operation was small, the regulations apparently were adopted to simplify recordkeeping for the farmer. The statutory rules permitting deductions for soil and water conservation, land clearing expenses, and fertilizer costs were added between 1954 and 1962 to encourage conservation practices. The special requirements for capitalizing outlays for citrus and almond growers were enacted in 1969. The exclusion for certain cost-sharing payments was enacted in 1978.

The Tax Reform Act of 1976 required accrual accounting for some farm corporations, and restricted deductions associated with tax shelters, in recognition, respectively, of the more sophisticated accounting methods available to some corporate farmers, and the growth of tax shelters.

The remaining use of cash basis accounting for individual and some corporate farmers is still justified by its proponents as simpler, more workable, and more consistent than the accrual method.

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(350) Agriculture

CAPITAL GAINS TREATMENT OF CERTAIN INCOME

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	430	25	455
1983	455	25	480
1984	475	30	505
1985	500	30	530
1986	525	35	560
1987	550	35	585

Authorization

Sections 1201–1202, 1221–1223, 1231, 1245, and 1251–1252.

Description

If gains from the sale or exchange of property used in a trade or business exceed losses from such property in any year, the gain is treated as a long-term capital gain. Long-term capital gains are taxed at lower maximum rates than ordinary income.

Real estate or depreciable property used in farming operations and held for more than a year, but not held for sale, generally qualifies as such property. However, horses and cattle qualify as property used in a trade or business only if they have been held more than 24 months.

In some cases, all or much of the cost of the farm property used in the business has previously been deducted under the farm accounting rules discussed elsewhere. Consequently, in 1969, Congress enacted legislation to tax as ordinary income some gains previously taxed as capital gain. These gains include those from the sale of land held for less than 10 years, but only to the extent of previously deducted soil and water conservation expenses. They also included gains from other farm property to the extent of the amount in the taxpayer's excess deduction account. The excess deduction account was the cumulative total of farm losses which exceeded $25,000 in any year when nonfarm income exceeded $50,000. The excess deductions account was reduced by net farm earnings and gains that were treated as ordinary income. Under the 1976 Tax Reform Act, which restricted farm loss deductions, additions to

this excess deductions account for 1976 and later years were terminated. Recapture provisions will still apply, however, to the extent of previously accumulated amounts in excess deductions accounts.

Impact

Subject to these rules, taxpayers owning farm assets may obtain long-term capital gains treatment on qualifying assets even though much of the cost of the assets has been deducted against ordinary income. While this favorable tax treatment is limited to property used in the farming business, many farm assets have a dual potential of being held for sale or for use in the business. Assets having this ambiguous nature are often sold before the ambiguity is resolved, and the gain is treated as capital gain.

Over 90 percent of the tax saving is claimed by noncorporate farmers. The tax benefit per dollar of capital gain increases with the taxpayer's marginal tax rate.

In the past, the interaction between the deduction of costs and capital gains treatment for the sale of such assets resulted in many tax shelter operations in farming. However, restrictions on farm loss deductions enacted in 1976 (discussed elsewhere), have limited the attractiveness on farm tax shelters in general.

Rationale

Preferential treatment for capital gains for individuals was introduced in 1921. However, long-term capital gain treatment for property used in a trade or business was not enacted until 1942. Between 1942 and 1951, there was a dispute whether livestock qualified as such property, and legislation in 1951 gave livestock that status. The 1942 legislation was enacted to provide tax relief for war-related gains. Restrictions on loss deductions were enacted in 1976 to limit the use of farming tax shelters.

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DEDUCTIBILITY OF PATRONAGE DIVIDENDS AND CERTAIN OTHER ITEMS OF COOPERATIVES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	−375	920	545
1983	−390	950	560
1984	−400	980	580
1985	−410	1,010	600
1986	−425	1,040	615
1987	−435	1,075	640

Authorization

Sections 1381-1388.

Description

A cooperative is allowed to deduct earnings distributed to its customers (or patrons) in the form of "patronage dividends" or "per unit retain" allocations. Patronage dividends must be determined on the basis of the quantity or value of business done with the patron, and by reference to the cooperative's earnings from business with patrons. Per unit retain allocations are based upon the quantity of products marketed without reference to the cooperative's earnings.

The deduction applies to both cash dividends and noncash dividends in the form of certificates allocating amounts—retained by the cooperative—to the patrons. In order for a cooperative to deduct the noncash patronage dividends: (1) at least 20 percent of the allocation must be in cash; and (2) the allocation must be included in the patron's income, unless it is related to personal, nonbusiness expenses. Per unit retains also may be deducted by the limited types of cooperatives that can issue them, although the retains only represent allocations of earnings to patrons and are not cash dividends. A patron must treat all his patronage dividends and per unit retain allocations as taxable income.

Impact

The deduction of patronage dividends, and particularly noncash dividends, allows a cooperative effective exemption from the corporate income tax, while the cooperative still retains its earnings for reinvestment through the use of certificates of allocation. For example, if all dividends were paid in allocations, a cooperative could retain 80 percent of its earnings and incur no Federal income tax liability.

The most significant cooperatives qualifying for this treatment are agricultural cooperatives, although substantial numbers of nonagricultural cooperatives, such as consumer cooperatives, also benefit from these provisions. Cooperative credit institutions are not eligible for this special treatment, although they do benefit from other tax expenditures. Qualifying cooperatives either may be purchasing or marketing cooperatives, and may be involved in manufacturing processes as well. Exemption from the Federal income tax provides a competitive advantage for cooperatives, many of which are substantial in size, over competing incorporated businesses.

Rationale

The treatment of patronage dividends derives initially from rulings issued early in the 1920's which allowed patronage dividends to be deducted by cooperatives. There was no explicit rationale for such treatment, but apparently the rulings resulted from the requirement that cooperatives make these dividends payments. It was argued these payments either were costs of goods sold or price reductions, and therefore should be deductible.

In 1951, when certain formerly exempt cooperatives were made taxable, a requirement was added that patronage dividends of exempt and nonexempt cooperatives be treated in the same manner. The legislative history indicates that the intent of the Congress was to tax all earnings of cooperatives either to the patron, stockholder, or cooperative. However, when the Treasury attempted to tax allocated patronage dividends to the patrons, a series of court decisions ending with *Long Poultry Farms Inc.* v. *Commissions,* 249 F.2d 726 (4th Cir. 1957), held that allocation certificates were of contingent value and were not to be included in income. Thus, such allocations were taxable neither to the cooperative nor the patron. As a consequence, sections 1381–1388 were added in 1962 to insure that such allocations were taxable either to the patron or the cooperative.

Further Comment

Two theories are advanced for allowing the deduction of patronage dividends. The first is that such dividends actually constitute price reductions to the patrons. The second is that all earnings of the cooperative belong to its patrons, and that the cooperative is an agency of its members rather than a separate taxable enterprise.

On the other hand, current tax law treats cooperatives as taxable entitities, and the deduction of patronage dividends results in effective tax exemption. Allocated patronage dividends arguably do not

constitute price reductions, but rather are nonnegotiable, non-interest-bearing notes redeemable by the patrons, if ever, in the indefinite future. One might question why patrons accept such allocations in lieu of cash if the intent is a price reduction. The answer may be that the interest of the patrons is that of investors. This response is particularly relevant since cooperatives are typically owned, either through stock ownership or otherwise, by patrons.

Persons arguing that patronage dividends are not comparable to price reductions note that price reductions in a normal business have a profit motive—expanding sales and increasing profit. So-called price reductions for cooperatives in the form of patronage dividends, however, have the purpose of eliminating profit.

It is argued by some that even if the patronage dividends and per unit retains are viewed as dividends, the tax rules governing cooperatives do not result in a tax expenditure because the patrons are taxed on the dividends and retains they receive or have attributed to them. In effect, the patrons are taxed as if they receive cash dividends and reinvest them in the cooperatives. However, the estimated revenue foregone by allowing the cooperatives full deductions for these dividends and retains far exceeds the estimated additional tax revenues paid by patrons on their patronage dividends and per unit retains.

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EXCLUSION OF CERTAIN COST-SHARING PAYMENTS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	60		60
1983	50		50
1984	45		45
1985	40		40
1986	30		30
1987	25		25

Authorization

Section 126.

Description

There are a number of programs under which the Fedral Government makes payments to taxpayers which represent a share of the cost of certain improvments made to land. Beginning with certain grants made by the Federal Government after September 30, 1979, under certain specified programs, a portion of the value of improvements financed by the grant is excluded from the recipient's gross income.

To qualify for the exclusion, the Secretary of Agriculture must determine that the payment is made primarily for the purpose of conserving soil and water resources or protecting the environment. Also, the Secretary of the Treasury must determine that the payment does not result in a substantial increase in the annual income derived from the property with respect to which the payment is made. The taxpayer is not permitted to claim the otherwise allowable deductions or credits with respect to amounts excluded under this provision.

Impact

The grants which result in exclusions from gross income do not improve the income-producing capability of the property. Also, since the grant moneys are expended by the taxpayer, he does not have additional funds to pay income tax on the grants. The income

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tax exclusion provides a general incentive for soil and water conservation measures that might not otherwise be undertaken.

Rationale

The partial exclusion for certain soil and water conservation payments is based on the premise that the improvements financed by these grants benefit both the general public and the individual landowner. The portion of the value of the improvement financed by grant payments attributable to public benefit is excluded from the recipient's gross income while that portion of the value primarily benefiting the landowner (private benefit) is properly taxable to the recipient of the payment.

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DIVIDEND EXCLUSION

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	2,185	.....	2,185
1983	550	.....	550
1984	555	.....	555
1985	580	.....	580
1986	605	.....	605
1987	635	.....	635

Authorization

Section 116.

Description

An individual may exclude dividends of up to $100 ($200 on a joint return without regard to which spouse actually receives the dividends) received from domestic corporations.

Impact

Although this provision benefits all taxpayers who receive dividend income and have tax liability, only a small percentage of total dividends is affected by the provision because of the dollar limitation. The tax saving per dollar of exclusion increases with the taxpayer's marginal tax bracket. In the aggregate, the benefits tend to accrue to middle- and high-income taxpayers because they are more likely to own stock.

Rationale

In 1954 a dividend exclusion of $50 and a credit against tax liability for 4 percent of dividends above that amount were adopted. The stated purpose was to provide partial relief from the "double taxation" of dividends (the corporate income tax and the individual income tax on dividends) which, it was argued, hampered, the ability of companies to raise capital. The exclusion was stated to be designed to afford greater relief for the low-income investor.

In 1964, although the administration recommended repeal of both the credit and exclusion, the credit was repealed and the ex-

clusion was doubled. The reasons offered were (1) that the provisions had not achieved their objectives, (2) the change would remove the discrimination in favor of high-income taxpayers, (3) the change would encourage broader ownership of stock, and (4) the change would raise revenues that could be used to reduce the individual taxes in general.

Further Comment

As indicated above, the issue that gave rise to the initial enactment of the exclusion and credit is the "double taxation" of dividends or, more generally, the burden of taxes on capital, and on corporate equity capital in particular. While the exclusion survives, it does relatively little to resolve this problem because of the low dollar ceiling. Many proposals for partial and full integration of the corporate and individual income taxes have been made. Partial integration proposals were seriously considered, but not proposed, by the Carter administration in 1977. They have also been the subject of congressional hearings, and have been discussed in recent years in the House Ways and Means Committee.

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REINVESTMENT OF DIVIDENDS IN STOCK OF PUBLIC UTILITIES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	130		130
1983	365		365
1984	415		415
1985	450		450
1986	280		280
1987			

Authorization

Section 305(e).

Description

Normally, the distribution by a corporation of its own shares of stock to a shareholder where the shareholder has the choice of receiving either stock or other property (including money) is treated as a taxable dividend to the extent of the corporation's earnings and profits.

Under this provision, a shareholder of a public utility may exclude up to $750 ($1,500 in the case of a joint return) of common stock received under a plan giving the shareholder the option to receive his or her distribution as either stock or other property. The provision is in effect only through 1985.

Impact

The provision encourages shareholders of public utilities to reinvest their dividends in the public utility rather than withdrawing the funds to use for other purposes.

Rationale

Because property of public utilities is generally recovered over a longer period of time than property of other industries, this provision allows utilities to raise additional capital from shareholders through the reinvestment of dividends and reduces the amount of capital that would be raised from other external sources.

Further Comment

This provision was added to the Internal Revenue Code by the Economic Recovery Tax of 1981.

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NET INTEREST EXCLUSION

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982			
1983			
1984			
1985	1,115		1,115
1986	3,090		3,090
1987	3,425		3,425

Authorization

Section 128.

Description

Beginning in 1985, individuals will be allowed an exclusion equal to 15 percent of up to $3,000 of net interest income ($6,000 for those filing joint returns). Net interest is generally defined as eligible interest received in excess of interest expense claimed as an income tax deduction but not including mortgage interest or trade or business interest. Eligible interest includes interest from banks, savings institutions insured under Federal or State law, indebtedness of domestic corporations, government debt, trusts established under Federal law, and insurance companies.

Impact

This provision provides a limited personal savings incentive. Taxpayers with interest income of less than $3,000 ($6,000 for joint returns) would realize an increased after tax rate of return upon their net saving of between 2 and 15 percent depending upon their marginal tax rate which would be between 11 and 50 percent respectively. Taxpayers with interest income in excess of the $3,000 or $6,000 limitation receive no additional incentive. Interest expense other than home mortgage interest and trade or business interest (presumably for consumption expenditures) reduces the exclusion dollar for dollar. This increases the effectiveness of the incentive as compared to a simple exclusion when a taxpayer borrows to make an interest-income-producing investment. The overall amount of saving in the economy would not have changed.

Rationale

The personal savings rate over the past 5 years has hovered around 5½ percent. This has been a contributing factor to reduced investment and growth over that same period. The net interest exclusion is designed to reverse those trends.

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EXCLUSION OF INTEREST ON STATE AND LOCAL INDUSTRIAL DEVELOPMENT BONDS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	315	1,295	1,610
1983	410	1,690	2,100
1984	525	2,160	2,685
1985	650	2,670	3,320
1986	790	3,235	4,025
1987	945	3,875	4,820

Authorization

Section 103(b).

Description

The interest on industrial development bonds (IDB's) issued by state and local governments to finance eight categories of investment is excludable from gross income regardless of issue size. The eight categories are: (a) residential family housing, (b) sports facilities; (c) convention or trade show facilities; (d) airports, docks, wharves, mass commuting facilities, and parking facilities; (e) sewage or solid waste disposal facilities or facilities for the local furnishing of electric energy or gas; (f) air or water pollution control facilities; (g) facilities for furnishing water made available to the public; and (h) the acquisition or development of land for an industrial park.

The interest on IDB issues that finance other types of industrial plant and equipment investments is generally not excludable from gross income unless the issue has a face value of $1 million or less. Under certain conditions, a state or local government can elect to raise this limit to $10 million. These small issues, which are used to finance a wide variety of enterprises from manufacturing plants to tennis courts, account for the largest share of all tax-exempt bonds floated for private purposes. In 1980, small issues amounted to more than $8.4 billion (up from $7.1 billion in 1979) and made up about 15 percent of all 1980 long-term tax-exempt bond issues. Preliminary indications are that the volume of IDB issues in 1981 may have been as much as 40 percent greater than in 1980.

Unlike general obligation issues, industrial development bonds are not backed by the issuing government. Rather, the bonds are guaranteed by a business. The issuer uses the proceeds of the bonds to finance the investment in plant and equipment that the business intends to utilize. Typically, the issuer leases the equipment back to the private firm, including in the rent the interest costs of financing the bond issue. The backing for the bonds may be the credit of the borrowing firm, the revenue from the projects financed, or the funded facility itself. If the borrower defaults, the bondholders bear the loss.

Impact

Tax-exempt IDB's subsidize private investments. Since interest on IDB's is tax exempt, potential purchasers are willing to accept lower before-tax rates of interest than on taxable securities. Consequently, the issuing government can attract bondholders with lower interest payments than corporations selling comparable bonds in the taxable market. By financing investment through IBD's, a private firm can, therefore, lower its borrowing costs.

Benefits of the tax exemption are conferred on both the holders of IDB's and the private firms using them as financing mechanisms. The allocation of benefits between the holders and the businesses depends on the spread in interest rates between the tax-exempt IDB market and the taxable bond market. The smaller the spread, the larger the proportion of benefits accruing to the IDB bondholders.

Because it is an exclusion from income, the value of this tax expenditure increases with the marginal tax rate of the bondholder. Consequently, within the household sector, IDB's tend to be held by high-income investors. In general, fire and casualty insurance companies have been attracted to IDB's because of their relatively high yields and long maturities. Commercial banks, the other major group of institutional investors in the municipals market, hold most unrated, privately placed IDB's. In the past year, however, both banks and insurance companies have grown reluctant to increase their IDB holdings for a variety of reasons, including lower profits, the availability of alternative means of shielding income from taxation, and the relative illiquidity of unrated bonds. Some banks are now backing IDB's with their letters of credit, making it possible to sell the bonds to individual investors in tax-exempt bond funds. As a result of the reductions in individual tax rates enacted in 1981, however, demand for tax-exempt bonds among individuals is also shrinking. In consequence, the ratio of tax-exempt to taxable interest rates has been rising, and the relative savings resulting from the use of tax-exempt financing have been declining.

Rationale

The tax-exempt status of industrial development bonds was originally established in the courts on the ground of state sovereignty. Mississippi issued the first industrial development bonds in 1936 as part of legislation to "Balance Agriculture with Industry" (BAWI). In 1938, the Mississippi Supreme Court upheld the constitutionality

of the Mississippi Act. The U.S. Supreme Court dismissed a subsequent appeal for lack of a substantial federal question.

Many early IDB issues were intended to promote industrial development, particularly in agricultural labor surplus areas during the Great Depression. IDB's continued to be used predominately for this purpose through the 1940's and 1950's, mostly in the Southeast. During the 1960's, the number and size of issues increased and IDB-financed facilities spread into urban areas and other regions. Between 1959 and 1968, the number of reported issues rose from 88 to 212, and the dollar value of issues rose from $32.4 million to an estimated $1.8 billion. By 1968, IDB's were in use in some 40 states.

Dollar limitations were placed on the size of tax-exempt IDB issues in 1969 for several reasons: the growing revenue loss to the Federal Treasury; the intensification of financially debilitating competition for industry among municipalities through the extension of IDB financing; the substantial use of IDB's by large corporations that already had ample financial resources; and the pressure on interest rates throughout the municipals market generated by IDB growth.

Further Comment

In February 1982, the Reagan Administration proposed that assets financed with tax-exempt bonds issued after 1982 be depreciated using the straight-line method over an extended recovery period, instead of the accelerated depreciation permitted under the Economic Recovery Tax Act of 1981. This would affect the use of tax-exempt bonds for all privately-owned facilities. In addition, the Administration proposes that tax-exempt financing be limited to bonds that are publicly approved by local governments and which, after 1985, receive a financial contribution or commitment from the local government. Small issue IDB's would not be allowed for large businesses.

These proposals could result in significant cutbacks in the use of tax-exempt bonds for private purposes, but much will depend on the ratio of tax-exempt to taxable yields. At present, tax-exempt yields are about 80 percent of taxable yields, which would make firms in the 46 percent tax bracket virtually indifferent between accelerated depreciation and tax-exempt bonds. (Most firms using IDB's are in the 46 percent bracket.) Since taking advantage of the accelerated depreciation provisions of the tax law would require no local government approvals, firms would more than likely not use tax-exempt financing. If, however, tax-exempt yields move back to their historical level of 70 percent of taxable yields, most firms would opt for tax-exempt financing.

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(370) Commerce and Housing Credit

EXCLUSION OF INTEREST ON CERTAIN SAVINGS CERTIFICATES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	400		400
1983	1,790		1,790
1984	1,140		1,140
1985			
1986			
1987			

Authorization

Section 128.

Description

Interest earned on qualified tax-exempt savings certificates is excludable from an individual's gross income, not to exceed a lifetime aggregate of $1,000 ($2,000 in the case of a joint return). In general, qualified tax-exempt savings certificates are 1-year certificates available in $500 denominations, issued after September 30, 1981, and before January 1, 1983, by a qualified depository institution. The certificate must have a yield exactly equal to 70 percent of the yield on the most recently issued 52-week Treasury bills.

A qualified depository institution is a bank defined in section 581, a mutual savings bank, cooperative bank, domestic building and loan association, credit union, or any other savings or thrift institution chartered and supervised under Federal or State law, if the deposits or accounts of the institution are insured under Federal or State law or protected or guaranteed by State law.

Generally, at least 75 percent of the proceeds from qualified tax-exempt savings certificates must be used for residential financing or agricultural loans, except for credit unions which have other limitations on the amount of savings certificates they may issue. Residential financing includes two, three, and four family residences and loans on stock of a cooperative housing corporation.

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Impact

The lifetime exclusion of $1,000 ($2,000 on a joint return) of interest on tax-exempt savings certificates provides individual taxpayers with tax-free interest which, under normal circumstances, would be taxable as ordinary income. As an exclusion, the value of this tax expenditure increases with the marginal tax rate of the savings cerficate holder. Thus, taxpayers in the 50-percent bracket receive a greater benefit from the interest exclusion than taxpayers in lower brackets.

Rationale

Prior law did not include any specific provision for exclusion of interest earned on savings certificates, other than the provision in section 116 for the partial exclusion of a specified annual amount of dividends and interest received by individuals. During recent periods of high interest rates, building and loan associations, commercial banks, credit unions, and similar depository institutions have experienced substantial disintermediation. Depositors and investors in institutional demand deposits, certificates of deposit, and other time deposits have transferred their funds to higher yield financial instruments purchased from other sources (such as money market funds) which, unlike depository institutions, are not subject to statutory limits on the rates of interest they can pay, nor do they have to meet minimum reserve requirements.

In addition, because of the high interest rates, the current cost to many banks and credit unions of obtaining funds to carry old long-term, low-rate loans, especially home loans, is higher than the income accruing on them. The resulting squeeze on the profitability and cash flow of many of these depository institutions may threaten their financial viability. Another result of high interest rates has been a significant disruption in the mortgage creidt market.

The temporary availability of a tax-exempt savings instrument which may be issued only by certain depository institutions will help to stem, and perhaps reverse, the flow of deposits out of these depository institutions while long-term solutions to the problems faced by these thrift institutions are developed. Furthermore, this tax expenditure provides incentives for new savings and requires that a portion of new deposits be invested in housing-related or agricultural loans.

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EXEMPTION OF CREDIT UNION INCOME

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982		110	110
1983		115	115
1984		120	120
1985		125	125
1986		135	135
1987		140	140

Authorization

Section 501(c)(14).

Description

Credit unions without capital stock, and organized and operated for mutual purposes and without profit, are not subject to Federal income tax.

Impact

Because their income is exempt from the income tax, credit unions are treated more favorably than are competing financial institutions whose income is taxed. On the other hand, credit unions are subject to certain special constraints not required of their competitors, such as limits on the interest rate charged on loans, on the duration of loans, and on the types of investments that are allowed. In addition, credit unions may lend only to members; however, only a small deposit may be required for membership that qualifies the member for a loan greatly in excess of the desposit.

Rationale

Credit unions have never been subject to the Federal income tax. Initially, they were included in the provision that exempted domestic building and loan associations—whose business was at one time confined to lending to members—and nonprofit cooperative banks operated for mutual purposes. The exemption for mutual banks and savings and loan institutions was removed in 1951, but credit

unions retained their exemption. No specific reason was given for continuing the exemption of credit unions.

Further Comment

The Carter Administration proposed in 1978 that credit unions no longer be exempt from the Federal income tax, but rather be treated in the same manner as thrift institutions. The Treasury Department indicated that the basis for this proposal was that many credit unions are no longer truly mutual institutions with limited "common bonds," and are becoming virtually indistinguishable from other financial institutions.

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EXCLUSION OF INTEREST ON LIFE INSURANCE SAVINGS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	4,535	.....	4,535
1983	4,805	.....	4,805
1984	5,165	.....	5,165
1985	5,790	.....	5,790
1986	6,615	.....	6,615
1987	7,245	.....	7,245

Authorization

Section 101(a) and case law interpreting Treas. Reg. 1.451-2.

Description

Most life insurance policies, other than term policies, accumulate interest-bearing reserves which benefit the policyholder by, in effect, reducing his premiums. However, this interest is not included in the policyholder's income for tax purposes as it accumulates. Pursuant to section 101(a), policy proceeds paid because of the death of the insured usually are not included in income. Therefore, when policy proceeds are not taxed at death, the previously accumulated interest is not taxed at all. If a policy is surrendered before death, only the excess of the cash surrender value over the premiums paid is included in income, with the result that the cost of the current insurance and initial expense charges can be offset against the interest income.

Impact

The effect of this exclusion allows personal insurance to be partly purchased with tax-free interest income. Although the interest earned is not currently paid to the policyholder, he may receive the interest payments if he terminates the policy. In the case of a surrender, the deferral of tax on this income is equivalent to an interest-free loan. Furthermore, there is usually no taxable income at death or on other payments of the proceeds, and thus the interest income is usually exempt from tax.

This provision thus offers preferential treatment for the purchase of life insurance coverage and for savings held in life insurance policies. Because middle-income taxpayers are the major purchasers of this insurance, they are the primary beneficiaries of the provision. Higher income taxpayers who are not seeking insurance protection can generally obtain comparable, if not better, yields from tax-exempt State and local obligations, though insurance yields theortically could approach those of taxable securities.

Rationale

The exclusion of death benefits dates back to the 1913 tax law. While no specific reason was given for exempting such benefits, insurance proceeds may have been excluded because they were believed to be comparable to bequests, which also were excluded from the tax base.

The nontaxable status of the interest as it accumulates is based upon the general tax principle of "constructive receipt," that is, income is taxable to a cash basis taxpayer only when it is received by, or readily available to, him. The interest income is not viewed as readily available to the policyholder because he must give up the insurance protection by surrendering the policy in order to obtain the interest.

Further Comment

Although significant practical, social, and legal questions would be involved, the interest component could be taxed as earned or could be taxed when the proceeds are paid. Taxing the interest element when the proceeds are paid would still defer tax for the period from when it is earned until the time the proceeds are paid, but would require that the tax be paid upon death.

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EXCESS BAD DEBT RESERVES OF FINANCIAL INSTITUTIONS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982		250	250
1983		515	515
1984		765	765
1985		905	905
1986		1,005	1,005
1987		1,085	1,085

Authorization

Sections 585, 593, and 596.

Description

In general, businesses are permitted to deduct as a current operating expense a reasonable allowance for bad debts. The allowance usually is based on the experience of prior years. However, the special formulae used by financial institutions to compute bad debt reserves permit deductions in excess of actual experience.

Commercial banks compute their bad debt deductions under either the experience method of the percentage of outstanding loans method. Prior to 1969, commercial banks were permitted a bad debt deduction of 2.4 percent of outstanding loans. The 1969 Tax Reform Act reduced this figure to 1.8 percent for years through 1975, and 1.2 percent from 1976–81. The 1981 Economic Recovery Tax Act provided for bad debt deductions for commercial banks equal to 1.0 percent of outstanding loans for taxable years beginning in 1982, and 0.6 percent for years after 1982 and before 1988.

As an alternative to this treatment available for commercial banks, mutual savings banks, building and loan associations, and cooperative banks are allowed a bad debt deduction equal to 40 percent of their taxable income, if the institution's assets comprise specified proportions of certain "qualified" assets, which for "thrifts" are essentially residential mortgages. The total bad debt reserve of thrift institutions may not exceed 6 percent of qualifying real property loans, or the percentage-of-net-income bad debt de-

duction will be disallowed. To qualify for the full 40-percent deduction, at least 82 percent of its assets in the case of a building and loan association or cooperative bank, or 72 percent of its assets in the case of a mutual savings bank, must be invested in "qualified" assets. The annual bad debt deduction under this percentage-of-net-income method will be reduced if the institution's investments fail to meet the required proportion of "qualified" assets.

The 1981 Economic Recovery Tax Act extended the percentage-of-net-income method of computing bad debt deductions to both mutual savings banks which convert into stock associations and to newly formed stock associations so long as the institution is operated as a savings institution and is subject to the same Federal or State regulatory scheme as a mutual savings bank chartered under Federal or State law. These stock associations may compute their bad debt deduction under this method under the same rules applicable to building and loan associations (i.e., 82 percent of their assets must be invested in qualified assets in order to receive the full 40-percent deduction and the reduction of the amount of the bad debt deduction if assets fail to meet the required amount).

Impact

Bad debt reserve deductions in excess of actual experience lower the effective tax rates of financial institutions, particularly thrift institutions, below the normal corporate tax rate of 46 percent. Apart from other means of reducing tax liability, the 40 percent bad debt allowance will result in a maximum effective tax rate for qualifying thrift institutions of 27.6 percent.[1] The 1981 act extended the percentage-of-net-income method of computing bad debt deductions to stock associations operated as savings institutions, and, to that extent, continued the incentive for these thrift institutions to hold qualified assets, such as residential mortgages.

Rationale

The tax treatment of commerical banks evolved separately from that of thrift institutions. The allowance for special bad debt reserves of commerical banks was first provided by IRS ruling in 1947, when there was fear of a postwar economic downturn. It was intended to reflect the banking industry's experience during the depression period.

The special treatment of bad debt reserves for thrift institutions was added by statute in 1951. Prior to that time, savings and loan associations and mutual savings banks were exempt from taxation, in most instances because they were viewed as mutual organizations rather than corporations. Upon removal of this tax-exempt status, special, and very favorable, treatment of bad debt reserves was provided for savings and loan institutions and mutual savings banks, which in effect left them virtually tax exempt for a number of years thereafter. Some of the same factors which led to their tax exemption probably account for the special allowance for bad debts, especially the belief that these institutions fill an important role in providing home mortgage funds.

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[1] 0.46 − 0.4 (0.46) = 0.276 (without taking the minimum tax into account.

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DEDUCTIBILITY OF NONMORTGAGE INTEREST IN EXCESS OF INVESTMENT INCOME

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	7,585		7,585
1983	7,690		7,690
1984	8,085		8,085
1985	8,625		8,625
1986	9,220		9,220
1987	10,010		10,010

Authorization

Section 163.

Description

A taxpayer may take an itemized deduction for interest paid or accured on nonbusiness indebtedness (for example, personal and auto loans and credit account purchases) in addition to home mortgages. This interest is deductible even to the extent it exceeds income from investments which the taxpayer holds.

Impact

This provision reduces net interest charges, and thereby reduces the cost of consumer purchases financed by debt. Because higher income taxpayers are more likely to itemize deductions, they are more likely to benefit from this provision than are taxpayers in lower brackets.

Under 1954 legislation, the deduction for carrying charges on most consumer credit (unless explicitly denominated "interest") was limited to about 6 percent on the declining balance of consumer debt. In more recent years, bank charge cards have proliferated, and the Internal Revenue Service has ruled that charges on those cards generally can be fully deducted as interest. On the other hand, purchases under deferred payment contracts usually remain subject to the limitation previously mentioned. Thus, the theoretical treatment of bank charge cards differs substantially from deferred payment sales where carrying charges are often not called

"interest." Whether this distinction is observed in practice is unknown.

Rationale

While the 1862 income tax statute did not contain a special provision for the deduction of interest, it was allowed. When the income tax was reinstituted in 1913, a special provision allowing the deduction of interest was included, apparently because of concern that interest might not be treated as a busness expense and deducted under the general business expense provision. At that time, no distinction was drawn between business and nonbusiness interest expense; presumably because the latter constituted a very small proportion of total interest expense. However, today the nonbusiness interest cost is perceived as a consumption item and hence different from business interest.

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DEDUCTIBILITY OF MORTGAGE INTEREST ON OWNER-OCCUPIED HOMES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	23,030		23,030
1983	25,490		25,490
1984	28,465		28,465
1985	32,770		32,770
1986	37,830		37,830
1987	44,360		44,360

Authorization

Section 163.

Description

A taxpayer may take an itemized deduction for mortgage interest paid on his owner-occupied home.

Impact

Homeowners are allowed to deduct their mortgage interest payments, even though the implicit rental income from their home (the income they could earn if the home were rented to someone else) is not taxed. Renters and the owners of rental property do not receive a comparable benefit. Renters may not deduct any portion of their rent, and while the owners of rental property may deduct mortgage interest, they must pay tax on the rental income they receive.

The home mortgage interest deduction thus encourages home ownership by reducing its cost in comparison to renting. The percentage of housing that is owner-occupied rather than rented has increased from around 43 percent in 1940 to about 65 percent today. Recent studies indicate that about 3 to 5 percentage points of that increase is due to the deductibility of mortgage interest and property taxes. (See the section in function 370 on the Deductibility of Property Tax on Owner-Occupied Homes.) The mortgage interest deduction has also contributed to the sharp increase in home prices in recent years; home prices rose about one and one-half

times as fast as prices in general during the 1970's. This has increased the value of homeownership as an investment, but at the same time has made it harder for first-time homebuyers to enter the market.

Because homeownership has been such a good investment during the last decade, it has diverted investment resources from rental housing and from business capital equipment and securities. The tax advantages of homeownership have weakened the demand for rental housing, thereby encouraging a decline in new rental construction and the conversion of existing rental units to condominiums and cooperatives. According to one recent study of investment flows, the share of disposable income used for net purchases of owner-occupied housing rose by more than half in the late 1970's, from 2.4 percent to 3.8 percent, while the share devoted to net financial investments fell from 4.3 percent to 1.0 percent.

Recent developments have reduced the investment value of homeownership, however. Fixed-rate, low-interest home mortgages are no longer generally available; individual income tax rates are being reduced as a result of the Economic Recovery Tax Act of 1981, reducing the per-dollar tax savings from deductions; and more attractive investment alternatives are becoming available. Money market funds pay high interest rates with relatively low risk, lower tax rates on capital gains in general have reduced the comparative advantage housing has had, and increased capital cost recovery allowances for business equipment and structures have increased the after-tax return from business investment. Nonetheless, homeownership retains significant tax advantages over other forms of investment.

Many homeowners receive little or no benefit from the mortgage interest deduction. As recently as 1978, more than 60 percent of all homeowners either had no mortgage or used the standard deduction and thus gained no direct benefit from the mortgage interest deduction. Of those with mortgages, only 62.5 percent claimed the deduction. Higher-income individuals receive greater proportional benefits from the deduction than those with lower incomes, not only because they have higher marginal tax rates, but also because higher income taxpayers are more likely to own expensive homes and to itemize deductions.

Rationale

The deductibility of interest from taxable income in the federal income tax dates from 1913. No explicit rationale for this provision was advanced at the time of its enactment, but committee reports and floor debates suggest that interest payments were viewed as reductions in income that should be taken into account in determining a person's ability to pay income tax. No distinction was made between interest payments for business and nonbusiness purposes. At that time most interest was a business expense and a cost of earning income; home mortgage and consumer borrowing were far less prevalent than today.

Currently, a major justification for the deductibility of home mortgage interest payments is the desire to encourage homeownership and stimulate residential construction. Homeownership can

encourage neighborhood stability, promote civic responsibility, and improve the maintenance of residential buildings.

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(370) Commerce and Housing Credit

DEDUCTIBILITY OF PROPERTY TAX ON OWNER-OCCUPIED HOMES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	10,065		10,065
1983	10,635		10,635
1984	11,055		11,055
1985	12,105		12,105
1986	13,280		13,280
1987	14,805		14,805

Authorization

Section 164.

Description

Taxpayers may take an itemized deduction for property taxes paid on owner-occupied homes.

Impact

Like the deduction for home mortgage interest, the deduction for property taxes serves to reduce the cost of homeownership, push up home prices, and increase the investment value of homeownership. (See the section in function 370 on the Deductibility of Mortgage Interest on Owner-Occupied Homes for more detail on these effects.) The deductibility of property taxes has the additional effect of making it possible for states and localities to impose and collect somewhat higher property taxes than they otherwise could, since the deductibility of the tax lessens its burden somewhat and may reduce homeowner resistance to higher property taxes. It thus has effects similar to a general revenue sharing program. Like all deductions, the property tax deduction provides uneven tax savings per dollar of deduction; the tax savings are higher for those with higher marginal tax rates, and those homeowners who do not itemize their deductions receive no direct tax savings at all.

Rationale

The deductibility of real propety taxes dates from the beginning of the Federal income tax. A major rationale for the deduction was that nonfederal tax payments reduce disposable income and thus should be deducted when determining a taxpayer's ability to pay the Federal income tax. The deduction has also been viewed as an important way of promoting fiscal federalism. By allowing property taxes to be deducted in the same way as all other state and local taxes, the Federal Government avoids interfering in State and local decisions on the type of tax to rely on. In addition, the deductibility of property taxes against the federal income tax helps to equalize overall effective tax burdens among States and localities; citizens in high-tax jurisdictions pay somewhat lower federal taxes as a result of their higher deductions, and vice versa.

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EXCLUSION OF INTEREST ON STATE AND LOCAL HOUSING BONDS FOR OWNER-OCCUPIED HOUSING

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	420	650	1,070
1983	535	835	1,370
1984	645	980	1,625
1985	670	1,005	1,675
1986	655	980	1,635
1987	640	960	1,600

Authorization

Section 103A

Description

The interest on bonds issued by state and local governments to provide mortgages on owner-occupied houses is tax exempt only for bonds issued before December 31, 1983, and until then only under certain circumstances. There are limits on the volume of bonds that can be issued in each State each year, on the purchase prices of the houses that can be financed, and on the difference between the interest rate on the bonds and the interest rate on mortgages financed with bond proceeds. In addition, with a few exceptions the purchasers of the houses must be first-time homebuyers, and at least 20 percent of the lendable funds must be made available for mortgages in targeted areas. Bonds for veteran's housing are exempt from nearly all of these rules, including the sunset, provided that they are general obligation bonds.

The issuer of the bonds typically uses bond proceeds to purchase mortgages made by a private lender. The homeowners make their monthly payments to the private lender, which passes them through as payments to the bondholders.

Impact

Tax-exempt housing bonds subsidize private housing. Since interest on the bonds is tax exempt, investors are willing to accept

lower before-tax rates of interest than on taxable securities. Consequently, by financing housing through these bonds, the issuer can offer reduced mortgage interest rates.

Benefits of the tax exemption are conferred on both the bondholders and the homeowners who get their mortgages from them. The allocation of benefits between the bondholders and the homeowners depends on the spread in interest rates between the tax-exempt and taxable bond market. The smaller the spread, the larger the proportion of benefits accruing to the bondholders.

Tax-exempt bonds issued for owner-occupied housing totaled $11.8 billion in 1980 and $5 billion in 1981. These bonds constituted 21 percent of all long-term tax-exempt bonds issued in 1980 and 9 percent in 1981.

The largest purchasers of these bonds tend to be individuals in high tax brackets.

Rationale

Three states have issued tax-exempt bonds for veterans' housing since just after World War II. Tax exempt bonds for nonveterans' houses were first issued in the early 1970's by State housing agencies that already had programs for multifamily housing. In 1978, local governments began issuing bonds for owner-occupied housing. State and local governments usually direct the benefits of these programs to middle-income families. In some states (Alaska, Wisconsin, Rhode Island), most mortgages are financed by tax-exempt bonds.

The limitations imposed on these bonds by the Congress in 1980 were meant to: restrict their volume and the associated federal revenue loss and upward pressure on tax-exempt interest rates in general, direct more of the subsidy to the homebuyers—in particular first-time homebuyers purchasing moderately priced houses—and to upgrade targeted areas.

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EXCLUSION OF INTEREST ON STATE AND LOCAL HOUSING BONDS FOR RENTAL HOUSING

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	155	310	465
1983	170	345	515
1984	200	415	615
1985	255	525	780
1986	320	655	975
1987	380	780	1,160

Authorization

Section 103(b)(4)(A), Section 11(b) of the United States Housing Act of 1937, as amended.

Description

State and local governments can issue tax-exempt bonds under Section 103(b)(4) of the Internal Revenue Code to finance multifamily housing as long as 20 percent of the units are rented to low-income tenants (15 percent of the units in targeted areas). Most of the state agencies that have issued these bonds have done so to finance section 8 housing projects in which all tenants are low-income or handicapped. For these projects, the Federal Government pays a share of the rent of each tenant, based on the tenant's income and the fair market rent determined by the Department of Housing and Urban Development. Many local governments issue bonds to finance unsubsidized apartment buildings, and some bonds are issued for buildings insured by the Federal Housing Administration.

Under section 11(b) of the U.S. Housing Act of 1937, the Department of Housing and Urban Development (HUD) can authorize the issuance by local housing agencies and their instrumentalities of tax-exempt bonds for Section 8 housing projects. HUD also issues tax-exempt notes for public housing projects.

Impact

Because interest on these bonds is tax exempt, the bonds carry lower interest rates than comparable taxable bonds. The mortgages that they finance carry low interest rates that make profitable some apartment projects that otherwise would not be built. The subsidy is split among the bondholders, the owners of the apartment buildings, and the low-income tenants.

In 1981, about $1.2 billion in tax-exempt bonds for multi-family housing was issued under section 103(b)(4) of the Internal Revenue Code and section 11(b) of the Housing Act. In addition, $20 billion in tax-exempt federally guaranteed notes was issued in 1981 by HUD to finance public housing projects.

Rationale

Tax exemption on the bonds is believed to stimulate the construction of new multifamily housing and to counteract other provisions of the tax code that tend to favor owner-occupied as opposed to rental housing. The provision requiring that at least 20 percent of tenants be low income was added in 1981.

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(370) Commerce and Housing Credit

DEFERRAL OF CAPITAL GAINS ON HOME SALES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	1,525		1,525
1983	1,655		1,655
1984	2,020		2,020
1985	2,485		2,485
1986	3,010		3,010
1987	3,530		3,530

Authorization

Section 1034.

Description

Capital gains from the sale of a principal residence are excluded from taxable income when another residence costing at least as much is purchased within 2 years of the sale of the former one. In figuring the sale price, taxpayers may deduct the cost of any expense incurred "to assist in its sale." If the new residence costs less than the old, adjusted as indicated above, only the amount by which it falls short of the selling price of the old unit is taxed as a capital gain. The deferral is limited to one such sale during any one 2-year period, except for taxpayers whose move is "in connection with the commencement of work . . . at a new principal place of work."

Impact

Deferring the capital gains tax on home sales avoids putting an additional burden on owners who have to sell because of an increase in family size or an employment change. At the same time, this special tax treatment gives homeownership a competitive advantage over other types of investment, since 40 percent of the capital gain from investments in other assets is taxed when the asset is sold. As a result, savings are diverted out of other forms of investment and into housing.

Rationale

The deferral of capital gains from home sales was first introduced in 1951. Committee reports and floor debates at the time indicate that the Congress believed that taxing these capital gains imposed a "hardship," because capital gains may reflect only a general rise in housing prices—in which case the tax on the gain for homeowners who moved would reduce their ability to replace the home they had sold. The inequity was considered particularly great when such events as an increase in family size or a change in employment required the move. In that case, the sale of a house was said to have the character of an "involuntary conversion." Although the taxation of gains from other assets also made it impossible to acquire property having the same price as the assets sold without other sources of financing, the Congress singled out home sales for special treatment because they were considered to result mostly from personal reasons or uncontrollable circumstances, rather than the desire to make a profit.

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(370) Commerce and Housing Credit

EXCLUSION OF CAPITAL GAINS ON HOME SALES FOR PERSONS AGE 55 AND OVER

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	510		510
1983	550		550
1984	675		675
1985	830		830
1986	1,005		1,005
1987	1,175		1,175

Authorization

Section 121.

Description

Taxpayers age 55 and older are allowed a one-time exclusion from taxable income of $125,000 in capital gains on the sale of any property used as a principal residence during 3 of the previous 5 years.

Impact

This provision, together with the deferral of gains on previous home sales, allows older taxpayers to avoid some or all of the tax liability that would otherwise accrue from price increases in the value of their homes. Without this exclusion, many taxpayers who become renters would be required to pay tax on approximately the difference between the sale price of their final home and the purchase price of their first (less the accumulated costs of real estate commissions, transfer taxes, and the like). Since home prices have appreciated significantly in the last decade, the resulting tax liabilities could reduce the after-tax proceeds sufficiently to make it difficult to afford another home several years hence at current inflated prices, even though the actual tax rate on the gains would be 20 percent or less (only 40 percent of the gains would be included in taxable income). Thus, the deferral provision, without the one-time exclusion, could discourage some older taxpayers from selling their homes. On the other hand, the exclusion converts the continuing,

interest-free loan on tax liabilities that the deferral provides into a permanent forgiveness of tax liabilities. It thus compounds the favorable tax treatment created by the deferral of capital gains on home sales, and augments the special treatment given housing relative to other types of investment assets.

Rationale

The one-time exclusion is designed to shield older taxpayers from heavy tax burdens when they decide to become renters or move to a less costly residence. It is among the more recent homeownership provisions in the tax code. First introduced in 1964, it applied only to taxpayers 65 or older and then only under special circumstances. Full exclusion was available only when the sale price of the home did not exceed $20,000. For more expensive homes, only a portion of the gain could be excluded. The Revenue Act of 1976 subsequently increased the basic sale price figure to $35,000.

The Revenue Act of 1978 significantly liberalized the exclusion, increasing the amount of excluded gains to $100,000 and allowing all taxpayers 55 and older to claim it. It also reduced the required period of time that a unit had to serve as a taxpayer's principal residence from 5 of the last 8 years to 3 of the last 5. The 1978 act also allowed taxpayers whose previous residence had been "involuntarily converted" (that is, condemned or destroyed) to count toward the 3-year requirement the period spent in a replacement home or apartment. The Economic Recovery Tax Act of 1981 then raised the $100,000 amount to $125,000 ($62,500 in the case of married persons filing separately).

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(370) Commerce and Housing Credit

EXPENSING OF CONSTRUCTION PERIOD INTEREST AND TAXES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	275	505	780
1983	320	610	930
1984	390	735	1,125
1985	455	855	1,310
1986	515	975	1,490
1987	590	1,110	1,700

Authorization

Sections 163–164, 189.

Description

Interest and taxes incurred by a corporate taxpayer during the construction of a building either may be deducted or may be capitalized as a part of the depreciable base of the building. An individual taxpayer has the option of treating these costs either as a part of the depreciable base of the building, or as a separate capital cost to be amortized over specified time periods.

For nonresidential structures, the amortization period is 6 years for expenses paid or incurred in 1978. This 6-year period increases 1 year in each subsequent year, until it reaches 10 years in 1982. For residential buildings other than low-income housing, the pattern is the same except that the period begins at 4 years for expenses paid or incurred in 1978, and reaches 10 years in 1984. For low-income housing, construction period interest and taxes, may be deducted fully in the year they are paid or incurred, subject to limitations on prepayments.

Impact

The cost of interest and taxes paid or incurred during the construction period of a building is conceptually a cost of the constructed property. The allowance of such construction period costs as deductions when paid or incurred or over a period of time shorter than the useful life of the property results in a mismatch-

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ing of income and expenses by allowing the deduction of costs prior to the realization of income related to the costs. In contrast, all other construction costs are required to be capitalized and depreciated over the useful life of the building. The effect of the construction period interest and taxes deduction is a deferral of income taxes in the nature of an interest free loan.

Rationale

The deduction for interest and taxes was provided in the original income tax law in 1913. Although no specific rationale was stated, the legislative history suggests that such payments were viewed as reducing net income. In 1942, a provision was added to the law to allow taxpayers to elect to capitalize such costs. The Tax Reform Act of 1976 required the phased-in 10-year amortization period for individuals, which reflected a concern with the role this provision played in individual tax shelters. When interest and taxes were currently deducted, high income taxpayers could generate substantial immediate tax losses which could be used to shelter income earned from other sources.

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DEPRECIATION ON RENTAL HOUSING IN EXCESS OF STRAIGHT-LINE, AND DEPRECIATION ON BUILDINGS (Other Than Rental Housing) IN EXCESS OF STRAIGHT-LINE

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Depreciation on rental housing			Depreciation on buildings		
	Individuals	Corporations	Total	Individuals	Corporations	Total
1982	460	105	565	155	175	330
1983	575	130	705	190	210	400
1984	665	155	820	220	245	465
1985	720	165	885	245	280	525
1986	760	180	940	275	315	590
1987	795	195	990	310	350	660

Authorization

Section 167 (b) and (j).

Description

Taxpayers are allowed to recover the cost of their durable income producing assets that wear out or become obsolete by deducting from gross income an allocable portion of the cost of the assets. Normally these depreciation deductions are spread over the useful life of the asset, and the total amount equals the asset's cost (less salvage value for buildings placed in service by the taxpayer before 1981). Taxpayers are generally offered the choice of using the straight-line method (in which an equal amount of depreciation is deducted each year of the asset's life) or accelerated methods of depreciation (in which greater amounts are deducted in the early years). For buildings placed in service by the taxpayer before 1981, the taxpayer can switch from the declining balance or the sum of the years-digits methods of accelerated depreciation to straight-line depreciation when it becomes advantageous to do so as the asset grows older.

Accelerated depreciation on structures is allowed for all structures placed in service by the taxpayer after 1980. For structures

placed in service by the taxpayer before 1981, the use of accelerated depreciation is limited as follows:

Residental Rental Units

(1) New construction may be depreciated under any method allowed by the Internal Revenue Code.

(2) Used buildings having at least a 20-year life when acquired may be depreciated under the declining balance method using a rate not in excess of 125 percent of the straight-line rate.

Other Structures

(1) New construction may be depreciated by any accelerated method which does not yield depreciation greater than the declining balance method using a rate not exceeding 150 percent of the straight-line rate.

(2) Used buildings may be depreciated on the straight-line method or any other reasonable method that is neither a declining balance or sum of the years digits method.

If a building is sold at a gain, some of the accelerated depreciation will be recaptured as ordinary income. Without recapture rules, all of the gain would be taxed as capital gain. However, the recapture concept is not fully applied to low-income housing.

(See the section on "Real Property" in the description of "accelerated Depreciation on Equipment Other Than Leased Property," below.)

Example

Assume a used residential structure is put into service in 1980 with a basis of $10,000, an expected remaining life of 25 years, and no salvage value. If the straight-line method were used, the deduction would be $400 each year. Under accelerated depreciation, the first-year depreciation allowance can be computed as follows:

$$\text{Depreciation allowance} = 125\% \times 1/25 \times \$10{,}000 = \$500$$

In the second year, the depreciation allowance is computed in the same way except the original basis of $10,000 is now reduced by the amount previously depreciated. Hence, the new basis equals $9,500. The second year computation is:

$$\text{Depreciation allowance} = 125\% \times 1/25 \times \$9{,}500 = \$475$$

Thus, in each succeeding year, there is a decrease in the amount of depreciation claimed for tax purposes, and therefore an increase in tax liability compared to what it would be otherwise.

Impact

Because accelerated depreciation allows for larger deductions in the early years of the asset's life and smaller depreciation deductions in the later years, accelerated depreciation results in a deferral of tax liability. It is a tax expenditure to the extent it is faster than economic (i.e. actual) depreciation. It is widely believed to be consistent with actual experience to allow accelerated depreciation

for some machinery and equipment which, in many cases, decline in value more rapidly in their early years than later years. However, similar treatment for buildings is generally believed inconsistent with their rates of economic decline in value which are generally much slower than those of machinery and equipment.

The direct benefits of accelerated depreciation for structures accrue to owners of business buildings and rental housing. The benefit is estimated as the tax saving resulting from the depreciation deductions in excess of straight-line depreciation. About 81 percent of the tax saving from rental housing and 47 percent of the tax saving from nonresidential buildings are estimated to accrue to individual owners in FY 1978. The remaining portion of each class benefit goes to corporate owners.

Efforts to repeal accelerated depreciation for real estate have been opposed on the ground that without this treatment, real estate investments would be so unattractive relative to other forms of investment that drastic cutbacks in building would result. On the other hand, it is argued that the tax benefits increase the production of new buildings only to the extent that demand for new buildings responds to small price changes, and that this response is relatively small. The impact of accelerated depreciation on rental housing is generally estimated to be greater than for nonresidential buildings since the demand for housing is more price elastic.

In the economic Recovery Tax Act of 1981, a new system of accelerated depreciation for structures was enacted. Under the new system (ACRS), all structures may be depreciated over 15 years using a prescribed accelerated method. The prescribed accelerated method is based on the 175-percent delining balance method (200-percent declining balance for low-income housing). Taxpayers can elect to use the straight-line method over 15 years, 35 years, or 45 years.

Rationale

Prior to 1954, depreciation policy had developed through administrative practices and rulings. The straight-line method was favored by IRS and generally used. A ruling issued in 1946 authorized the use of the 150 percent declining balance method. Authorization for it and other accelerated depreciation methods first appeared in legislation in 1954 when the double declining balance and other methods were enacted. The discussion at that time focused primarily on whether the value of machinery and equipment declined faster in their earlier years. However, when the accelerated methods were adopted, real property was included as well, even though it did not decline more rapidly in value in its first years.

By the 1960's, most commentators agreed that accelerated depreciation resulted in excessive allowances for buildings. In 1964, a provision was enacted which "recaptured" accelerated depreciation as ordinary income in varying amounts when a building was sold, depending on the length of time the property was held. However, recapture was not required for straight-line depreciation upon the transfer of real estate. In 1969, the "recapture" provision was strengthened more in the case of commercial real estate which

became subject to full recapture, but also to some degree in the case of rental housing. The Tax Reform Act of 1976 provided for complete recapture of subsequent accelerated depreciation for all residential real estate except low-income housing, which continues to receive more liberal treatment.

In the Economic Recovery Tax Act of 1981, the recapture provisions were amended to provide for full recapture of all depreciation on nonresidential structures depreciated under the prescribed accelerated method made available under ACRS. However, if such structures were depreciated using the straight-line method under ACRS, only the accelerated depreciation would be recaptured. The acceleration of depreciation that results from using the 15-year recovery period under ACRS is not subject to recapture as accelerated depreciation.

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ACCELERATED DEPRECIATION ON EQUIPMENT OTHER THAN LEASED PROPERTY

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	845	6,455	7,300
1983	1,695	10,705	12,400
1984	2,540	16,080	18,620
1985	3,530	23,020	26,550
1986	5,140	33,140	38,280
1987	6,455	39,075	45,530

A. ACCELERATED COST RECOVERY SYSTEM

Authorization

Section 168.

Description

The Economic Recovery Act of 1981 replaced the prior law depreciation system with the Accelerated Cost Recovery System (ACRS). In general, ACRS applies to property placed in service after December 31, 1980.

ACRS is a system for recovering capital costs using accelerated methods over predetermined periods that are generally unrelated to, but shorter than, prior law useful lives. The ACRS methods of cost recovery and recovery periods are the same for both new and used property.

ACRS is mandatory for all eligible property. The recovery allowance provided under section 168 is deemed a reasonable allowance for depreciation under section 167(a), and eligible property may not be depreciated under the prior law rules of section 167. Thus, accelerated depreciation methods permitted under section 167 cannot be used for eligible property, and useful lives based on facts and circumstances or the ADR system cannot be used.

Special rules are provided to prevent the churning of used property between certain persons solely to obtain the increased investment incentives under ACRS. Property subject to these antichurning rules is not eligible for ACRS and must be depreciated under the depreciation rules in effect prior to 1981.

Personal Property

Under the new system, the cost of eligible personal property must be recovered over a 15-year, 10-year, 5-year, or 3-year period, depending on the type of property. Most eligible personal property is in the 5-year class. Cars, light-duty trucks, research and experimentation equipment, and certain other short-lived property are in the 3-year class. The 10-year class includes certain long-lived utility property, railroad tank cars, coal-utilization property, and certain real property described in section 1250(c). Other long-lived public utility property is in a 15-year class.

In general, the recovery deduction in each year of the recovery period is determined by applying a statutory percentage to the unadjusted basis of the property. In determining the annual deduction, the applicable percentage to be applied to the unadjusted basis of the property depends on the property's class and the number of years since the property was placed in service by the taxpayer ("recovery year"). The recovery deduction for the taxable year in which property is placed in service is based on the full recovery percentage prescribed in the statutory taxable for the first recovery year, regardless of when the property was placed in service during the taxable year. No recovery deduction is allowable in the year of an asset's disposition.

The schedules for personal property placed in service in 1981 through 1984 were developed to approximate the benefits of using the 150-percent declining balance method for the early recovery years and the straight-line method for the later recovery years. The schedules for personal property placed in service in 1985 were developed to approximate the use of the 175-percent declining balance method for the early recovery years and the sum of the years-digits method for the later recovery years. The schedules for personal property placed in service after 1985 were developed to approximate the use of the 200-percent declining balance method for the early recovery years and the sum of the years-digits method for the later recovery years. All of the schedules reflect the allowance of only a half-year of depreciation for the first recovery year and the allowance of the remaining recovery deductions over the remaining recovery years.

Taxpayers may use, in lieu of the prescribed accelerated percentages, percentages based on the straight-line method over the regular recovery period for the class or one of the two optional longer recovery periods for the class, as described above. Thus, a taxpayer can elect to use the straight-line method over 3 years, 5 years, or 12 years; for 3-year property, 5 years, 12 years, or 25 years for 5-year property; 10 years, 25 years, or 35 years for 10-year property; and 15 years, 35 years, or 45 years for 15-year public utility property.

Real Property

Real property has a 15-year recovery period. As an option to the 15-year recovery period, taxpayers may elect either a 35-year or 45-year extended recovery period. The election may be made on a property-by-property basis.

The taxpayer has an option to use (1) prescribed percentages based on an accelerated method over the regular 15-year recovery period or (2) the straight-line method over either the regular 15-year period or the optional longer recovery period chosen.

The accelerated percentages are to be determined under tables prescribed by the Department of the Treasury in accordance with the use of the 175-percent declining balance method (200 percent for low-income housing as defined in section 1250(a)(1)(B) (i), (ii), (iii), or (iv)), switching to the straight-line method at a time to maximize the recovery allowance. For the year of acquisition and disposition, the percentages are to be based on the number of months during those years that the property was in service.

Impact

ACRS represents a major change in the concept underlying the methods of cost recovery. The underlying concept of depreciation had been to match deductions for the cost of the assets with the income produced by their use. This objective was accomplished by recovery costs over useful lives as the assets declined in value. In general, the methods used were designed to accord with the actual pattern of loss of economic usefulness, although in practice the rates often varied from the actual rate of decline of the asset.

ACRS abandons the notion of matching income with the cost to produce that income. Instead, ACRS permits costs to be written off using fixed periods at a rate that is significantly faster, in general, than the rate under prior law depreciation or the rate based on the actual decline in value of the asset. ACRS is intended to provide an investment or capital formation stimulus rather than a net income determination. In that sense, ACRS is similar to the investment credit. The subsidy value of ACRS is the tax saving from permitting costs to be written off at a rate faster than the actual decline in value of the asset.

Rationale

In enacting ACRS, Congress concluded that prior law rules for determining depreciation allowances needed to be replaced because they did not provide the investment stimulus that was felt to be essential for economic expansion.

The real value of depreciation deductions allowed under prior rules has declined for several years due to successively higher rates of inflation. Reductions in the real value of depreciation deductions diminish the profitability of investment and discourage businesses from replacing old equipment and structures with more modern assets that reflect recent technology. The Congress concluded that a new capital cost recovery system was required to provide for more rapid acceleration of cost recovery deductions.

The Congress also felt that the prior law rules were too complex. These rules required determinations on matters, such as useful life and salvage value, which are inherently uncertain and, thus, too frequently resulted in unproductive disagreements between taxpayers and the Internal Revenue Service. Regulations under the prior rules provided numerous elections and exceptions which taxpayers—especially, small businesses—found difficult to master and ex-

pensive to apply. The Congress decided that a new capital cost recovery system should be structured which de-emphasized the concept of useful life, minimized the number of elections and exceptions, and made compliance and administration easier.

B. ASSET DEPRECIATION RANGE

Authorization

Section 167(m); Regulation 1.167(a)-11; Rev. Proc. 72-10.

Description

The Internal Revenue Service has established useful lives for classes of depreciable assets. The asset depreciation range (ADR) system permits taxpayers to choose any useful life within a range of 20 percent more or less than the class life otherwise established by the IRS for a particular asset. If ADR is chosen, the taxpayer is not required to justify retirement and replacement policies, nor to show that the useful lives selected for the assets are consistent with their actual useful lives.

Under the Economic Recovery Tax Act of 1981, the ADR system generally was repealed for property placed in service after 1980 and was replaced by a new system of accelerated cost recovery known as ACRS. Thus, the ADR system applies only to property placed in service by the taxpayer before 1981 and certain property placed in service after 1980 that is subject to "antichurning" rules under ACRS.

Example

Assume that a taxpayer has a $1,500 asset for which the class life established by the Internal Revenue Service is 10 years. Using double declining balance depreciation without ADR, the deduction in the first year would be 200 percent $\times$ .10 $\times$ $1,500 = $300. After deduction of this depreciation charge, the adjusted basis of the asset is $1,200 ($1,500 − $300). In the second year, the deduction would be 200 percent $\times$ .10 $\times$ $1,200 = $240.

Under the asset depreciation range, a useful life of between 8 and 12 years may be selected. If the taxpayer chooses 8 years, the first-year deduction would be 200 percent $\times$ ⅛ $\times$ $1,500 = $375. In the second year, the deduction would be 200 percent $\times$ ⅛ $\times$ $1,125 = $ 281.25. Therefore, the use of ADR would result in additional deductions of $75 the first year ($375 − $300) and $41.25 the second year ($281.25 − $240.00).

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SAFE HARBOR LEASING

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals		Corporations		Total	
	Accelerated depreciation and deferral	Investment credit	Accelerated depreciation and deferral	Investment credit	Accelerated depreciation and deferral	Investment credit
1982	.....	.....	1,285	1,365	1,285	1,365
1983	.....	.....	2,180	1,435	2,180	1,435
1984	.....	.....	3,285	1,780	3,285	1,780
1985	.....	.....	4,530	2,200	4,530	2,200
1986	.....	.....	5,785	2,730	5,785	2,730
1987	.....	.....	6,860	3,380	6,860	3,380

Authorization

Section 168(f)(8).

Description

In general, the benefits of depreciation and investment credit attributable to property are available only to the owner of the property. In many many cases, companies in a tax loss position and thus unable to use currently the tax benefits of ownership have been able to obtain a portion of those benefits indirectly by leasing the equipment from companies having sufficient taxable income to use the tax benefits. The use of the tax benefits may be reflected in reduced rental payments charged to the loss company. Prior to ERTA, the determination of whether these lease financing transactions should be treated for tax purposes in accordance with their form as leases or whether they should be recharacterized as in substance conditional sales or financing arrangements required a case-by-cased analysis.

ERTA provides a safe harbor guaranteeing a transaction will be treated as a lease, rather than a financing arrangement, even though the lesee is the owner for State law purposes and the transaction would not otherwise be a lease.

To be eligible for the safe harbor, the following requirements must be met:

(1) All parties to the agreement must elect;

(2) The nominal lessor generally must be a corporation (other than a personal holding company or subchapter S corporation);

(3) The lessor must have a minimum at-risk investment in the property at all times during the lease term of at least 10 percent of the adjusted basis of the property;

(4) The lease term must not exceed the greater of 90 percent of the property's useful life or 150 percent of the ADR midpoint life of the property; and

(5) The property must be qualified leased property.

If these requirements are met, the nominal lessor is treated as the owner of the property for Federal tax purposes. Thus, the lessor may claim all associated cost recovery allowances and investment credits.

Impact

The safe harbor leasing provision is a significant change overriding several fundamental principles of tax law. Traditionally, the substance of a transaction rather than its form controls the tax consequences of a transaction. In addition, a transaction generally will not be given effect for tax purposes unless it serves some business purpose aside from reducing taxes. Because the leasing provision was intended to be only a transferability provision, many of the transactions that will be characterized as a lease under the safe harbor will have no business purpose (other than to transfer tax benefits). When the substance of the transaction is examined, the transaction may not bear any resemblance to a lease.

For example, assume corporation X acquires 5-year recovery property with a 10-year economic life worth $1 million, but cannot use the tax benefits, X and corporation Y agree, pursuant to the safe harbor rules, that X will transfer the property in a paper transaction to Y but X will retain all economic benefits and burdens of ownership, including title for State law purposes. Y will then lease back the property to X for nine years at which time there will be a paper transfer of the property back to X for $1. Y agrees to pay X $200,000 in cash and to give X a note for $800,000 plus interest at the market rate. In return, X agrees to pay rent in an amount exactly equal to Y's $800,000 obligation plus interest.

Looking at the substance of the transaction between X and Y, which is cast in the form of a sale-leaseback, there has been no change of ownership and there is not business purpose for the transaction. X is still in actuality the owner and user of the property and Y has no profit from the transaction excluding tax benefits. However, since the transaction is treated as a sale to Y and leaseback to X under the safe harbor provisions, the Federal income tax law will recognize the form of the transaction producing the following economic consequences.

For Y, the present value of the tax savings due to cost recovery allowances, ITC, and interest deductions will exceed the present value of the tax on the rental income producing a return on Y's initial investment solely from tax savings. For X, the transaction results in a reduction of cost of $200,000, which is the amount of the up-front cash payment by Y.

Rationale

Under depreciation rules, prior to ERTA, many corporations were in a loss position and thus unable to utilize fully the tax benefits of depreciation deductions. Deductions that could not be used in a taxable year generated a net operating loss, which had to be carried back three years and forward seven years. Since, in most instances, the deductions permitted under the Accelerated Cost Recovery System (ACRS) are more accelerated than those permitted under prior law depreciation rules, the net operating losses of companies previously in a loss position would be increased and companies that previously were marginally profitable for tax purposes could be thrown into a loss position.

Although the flexibility provisions under ACRS and extension of the carryover period for net operating losses to 15 years will enable some companies to avoid loss of tax benefits, many capital intensive companies still will be unable to utilize fully their tax benefits. Moreover, even if the tax benefits can be carried over and used in later years, in present value terms the tax benefits are reduced. The safe-harbor leasing provisions under ERTA are designed to address this issue.

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AMORTIZATION OF BUSINESS START-UP COSTS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	65	5	70
1983	95	10	105
1984	130	15	145
1985	175	20	195
1986	230	25	255
1987	255	30	285

Authorization

Section 195.

Description

Costs incurred before the beginning of a business normally are not deductible because they are not incurred in carrying on a trade or business. These start-up costs normally must be capitalized and added to the taxpayer's basis in the business. Under section 195, a taxpayer may elect to deduct eligible start-up expenditures over a period of not less than 60 months.

In order to be eligible, an expenditure must satisfy two requirements. First, it must be paid or incurred in connection with creating, or investigating the creation or acquisition of a trade or business entered into by the taxpayer. Second, the expenditure must be one that would have been deductible for the taxable year in which it was paid or incurred, if it had been paid or incurred in connection with the expansion of an existing trade or business in the same field as that entered into by the taxpayer.

Impact

The election to amortize business start-up costs encourages the formation of new businesses by permitting the deduction of expenses that would have been deductible by an ongoing business. Without such an election, most of these startup costs would not be recovered by the taxpayer until the taxpayer sold his interest in the business.

Rationale

Before enactment of section 195 in 1980, the question of whether an expense incurred in creating or investigating the creation of a new business is currently deductible or must be capitalized had been the source of controversy and litigation with the Internal Revenue Service. Certain business organizational expenditures for the formation of a corporation or partnership could be amortized, on an elective basis, over a period of not less than 60 months (Code secs. 248 and 709).

In 1980, Congress added section 195 in order to encourage the creation of new businesses and reduce the controversy and litigation that surrounded the proper income tax classification of start-up expenditures.

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CAPITAL GAINS OTHER THAN AGRICULTURE, TIMBER, IRON ORE AND COAL

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	18,315	1,495	19,810
1983	14,390	1,710	16,100
1984	13,385	1,900	15,285
1985	14,225	2,100	16,325
1986	14,505	2,300	16,805
1987	14,685	2,500	17,185

Authorization

Sections 1201–1254.

Description

Gains on the sale of capital assets held for more than 1 year are subject to preferentially lower tax rates (see Appendix C). Also, gain on the sale of property used in a trade or business is treated as a long-term capital gain if all gains for the year on such property exceed all losses for the year on such property. Qualifying property used in a trade or business generally is depreciable property or real estate that is held more than 1 year, but not inventory.

For individual taxpayers, only 40 percent of long-term capital gains is included in income, which makes the maximum tax rate for such income 20 percent.

For corporate taxpayers, long-term capital gains generally require a dual tax computation. They are first included in income, and tax on the total income, including the capital gain, is computed using the regular rates. In the "alternative" computation, a tax on all income other than long-term capital gain is computed at regular rates. The long-term capital gain is taxed at a 28-percent rate, and the two resulting taxes are added together to yield the "alternative" tax. The lower of the tax computed the regular way or the "alternative" tax is the tax liability. Thus, a corporation must include the full amount of net long-term capital gains in taxable income, but may apply the special 28-percent alternative capital gain tax rate on the gain.

Gain on most depreciable tangible personal property used in a trade or business will be treated as ordinary income to the extent it arises from depreciation that has been allowed after 1961, i.e., the depreciation is "recaptured"; but only some depreciation on real estate is "recaptured."

The untaxed portion of capital gains is the principal tax expenditure subject to the minimum tax for tax preferences. This additional tax may offset a portion of the benefits of capital gains taxation for individuals and corporations with substantial annual capital gains.

Example

To illustrate the calculation of capital gains taxation for corporations, assume a corporation has, for the taxable year 1982, taxable income of $250,000, which includes net long-term capital gains of $60,000.

Tax computed in regular manner:	
Taxable income	$250,000
Tax	95,250
Alternative tax:	
Partial tax on $190,000 ($250,000—$60,000)	67,650
28 percent of $60,000	16,800
Alternative tax	84,450

The alternative tax is $10,800 less than the regular tax, and in this example the tax expenditure is the tax savings attributable to the alternative tax computation.

Impact

For individuals, the deduction from gross income of 60 percent of capital gains results in tax rates of 40 percent of the normal rates. The tax treatment of capital gains increases the after-tax earnings on assets, and thereby may encourage individuals to invest in assets which may appreciate in value. Furthermore, the tax preference may reduce the inhibiting effects of taxation on the sale of assets.

The benefits of this provision are concentrated among high income individuals, with approximately two-thirds of the benefit received by those with expanded gross incomes of $100,000 or more. The tax saving per dollar of capital gain increases with the tax bracket of the taxpayer.

Corporations with taxable income over $50,000 that realize income from the sale of long-term capital assets are the direct corporate beneficiaries of the general capital gains rules.

According to 1977 tax return data, net capital gains taxed at alternative rates averaged 5.6 percent of taxable income for all corporations. Aside from farming and timber, iron ore, and coal to which special capital gains rules apply, industries which had a high ratio of capital gains to ordinary income were real estate companies, and investment companies.

In cases in which the minimum tax applies to offset some of the benefits of capital gains taxation, it generally will increase the

maximum rate on capital gains by slightly more than 4 percentage points for corporations.

Rationale

Although the original 1913 income tax law taxed capital gains at ordinary rates, the 1921 law provided for an alternative flat rate tax for individuals of 12.5 percent. This treatment was to minimize the influence of the high progressive rates on market transactions. The Committee Report noted that these gains are earned over a period of years, but are nevertheless taxed as a lump sum. Over the years many revisions in this treatment have been made, including the temporary adoption of a sliding scale treatment (where lower rates applied the longer the asset was held) and an alternative capital gains rate for individuals which was repealed in 1978. Both the minimum tax on preference income and the maximum tax offset, which raise the capital gains rate for a limited number of taxpayers with capital gains, were first enacted in 1969 and then strengthened in 1976.

Prior to 1942, corporate capital gains were taxed in the same manner as ordinary corporate income. The 1942 act also introduced the alternative tax for corporations at a 25-percent rate, the alternative tax rate then in effect for individuals. This tax relief was premised on the belief that many wartime sales were involuntary conversions which could not be replaced during wartime, and that resulting gains should not be taxed at the greatly escalated wartime rates.

The alternative rate was raised to 30 percent in 1969 and lowered to 28 percent in 1978. The 28-percent rate adopted in 1978 was intended to apply the same maximum marginal rate to capital gains of corporations as applied to individuals.

Further Comment

Many reasons have been advanced for preferential treatment of capital gains income of individuals, with the major ones being: (1) capital gains are accrued over a long period of time, and should not be subject to tax under progressive rates as a lump sum; (2) capital gains reflect inflation to a substantial extent and are thus not real income; and (3) because an asset owner has discretion as to when to realize gains, the application of ordinary tax would act as a barrier to transactions in the capital market and lead to "lock-in" effects (asset owners refrain from selling because of the tax), with attendant distorting effects on savings, investment, and economic efficiency.

On the other hand, the following arguments have been advanced against the preferential treatment of capital gains: (1) even if capital gains were taxed as ordinary income, the advantage remains of the deferral of tax on unrealized gains; (2) inflation affects returns on assets in general, not just capital gains transactions; (3) the "lock-in" problem might be resolved in other ways, such as taxing gains transferred at death (thus removing the opportunity to avoid capital gains taxes entirely); and (4) the "bunching" problem can be met by a special averaging provision.

The effect of the difference in tax rates on ordinary income versus capital gains is different for corporations and individuals for a number of reasons. More of the capital gain for corporations results from sales in the normal course of business. Further, the ability to exempt gains from tax by death transfers is not available for corporations. Finally, there is less of a "bunching" problem for corporations since the corporate tax is graduated to a limited extent.

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CAPITAL GAINS AT DEATH

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	5,245		5,245
1983	3,975		3,975
1984	3,565		3,565
1985	3,665		3,665
1986	3,920		3,920
1987	4,195		4,195

Authorization

Sections 1001, 1002, 1014, 1015, 1023, 1040, 1221, and 1222.

Description

A capital gains tax generally is imposed on the increased value of a capital asset when the asset is sold or exchanged. However, this tax is not imposed on the appreciation in value when ownership of the property is transferred as a result of the death of the owner or as a gift during the lifetime of the owner. In the case of assets transferred at death, the heir's basis in the asset generally is the fair market value as of the date of decedent's death. Thus, no income tax is imposed on appreciation occurring before the decedent's death. In the case of gift transfers, the donee's basis in the property is the same as the donor's. Thus, if the donee disposes of the property in a sale or exchange, the capital gains will apply to the pretransfer appreciation.

Assets transferred at death or by *inter vivos* gift may be subject to the Federal estate and gift taxes, respectively, based upon their value at the time of transfer.

Impact

The exclusion of capital gains at death is most advantageous to individuls who need not dispose of their assets to achieve financial liquidity. Generally speaking, these tend to be wealthier individuals. The deferral of tax on the appreciation involved combined with the exemption for the appreciation before death is a significant benefit for these investors and their heirs.

Failure to tax capital gains at death encourages "lock in" of assets, which in turn means less current turnover of funds available for investment. In deciding whether to change his portfolio, an investor takes into account the higher pretax rate of return he might obtain from the new investment, the capital gains tax he might have to pay if he changes his portfolio, and the capital gains tax his heirs might have to pay in the future if he decides not to change his portfolio. Often an investor in this position decides that, since his heirs will incur no capital gains tax on appreciation that occurs before the investor's death, he should transfer his portfolio unchanged to the next generation. The lack of a tax on capital gains transferred at death or by gift provides a further incentive to this option. To the extent this option is taken, taxpayers are said to be "locked in" to investments.

Rationale

The original rationale for non-recognition of capital gains on *inter vivos* gifts or transfers at death is not indicated in the legislative history of any of the several interrelated applicable provisions. However, one current justification given for the treatment is that death and *inter vivos* gifts are considered as inappropriate events to result in the recognition of income.

The Tax Reform Act of 1976 provides that the heir's basis in property transferred at death would be determined by reference to the decedent's basis. This carryover basis provision was not permitted to take effect and was repealed in 1980. The primary rationale for repeal was the concern that carryover basis created substantial administrative burdens for estates, heirs and the Treasury Department.

Further Comment

Taxation of capital gains at death would cause liquidity problems for some taxpayers, such as owners of small farms and businesses. Therefore, most proposals for taxing capital gains at death would combine substantial averaging provisions, deferred tax payment schedules, and a substantial deductible floor in determining the amount of gain to be taxed.

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REDUCED RATES ON THE FIRST $100,000 OF CORPORATE INCOME

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982		6,605	6,605
1983		7,125	7,125
1984		8,065	8,065
1985		8,740	8,740
1986		8,660	8,660
1987		8,630	8,630

Authorization

Section 11.

Description

Corporate taxable income is subject to tax under a five-step graduated tax rate structure. The top corporate tax rate is 46 percent on taxable income over $100,000.

	Tax rate	
	1982	1983 and after
Taxable income:		
0 to $25,000	16	15
$25,000 to $50,000	19	18
$50,000 to $75,000	30	30
$75,000 to $100,000	40	40
Over $100,000	46	46

Impact

These reduced rates are available to all corporations. They reduce tax liability from a flat rate 46 percent tax for a corporation with $100,000 of taxable income by $19,750 in 1982 and by $20,250 in 1983. This tends to neutralize the tax differential between a

business operating as a sole proprietorship or a partnership and a corporation by lowering the corporate tax rate on the first $100,000 to rates comparable to the individual rates.

The graduated rates encourage the use of the corporate structure and allow some small corporate businesses that might otherwise operate as sole proprietorships or partnerships to provide fringe benefits. They also encourage the splitting of operations between sole proprietorships, partnerships, and corporations. Most businesses are not incorporated; only about 5 percent of all businesses are affected by this provision, and not all of those receive the full tax benefit because their taxable income is less than $100,000.

Rationale

Since almost the earliest days of the corporate income tax, some level of profits has been exempted from the full corporate tax rate. The split between a normal tax and a surtax was not, however, fully accomplished until the Revenue Act of 1941. The purpose was to provide relief for small busineses. However, many large businesses fragmented their operations into numerous corporations to obtain numerous exemptions from the surtax. Some remedial steps were taken in 1963; in 1969, legislation was enacted limiting groups of corporations controlled by the same interest to a single surtax exemption. Expanded temporary exemptions were first enacted in 1975, and were continued in 1976 and 1977. The present corporate tax rates were enacted in the 1981 Economic Recovery Tax Act.

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INVESTMENT CREDIT, OTHER THAN ESOPs, REHABILITATION OF STRUCTURES, REFORESTATION AND LEASING

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	3,475	14,970	18,445
1983	3,825	14,825	18,650
1984	4,205	19,775	23,980
1985	4,625	22,825	27,450
1986	5,090	22,550	27,640
1987	5,595	23,555	29,150

Authorization

Sections 38 and 46–50.

Description

The investment tax credit (ITC) is available to any taxpayer who invests in income-producing property that is eligible for the credit.

Eligible investment is largely limited to tangible personal property, such as machinery and equipment, that is used in the United States. Most buildings are not eligible.[1]

The credit is generally 10 percent of the qualified investment. The amount of credit is subtracted from tax liability calculated without the credit. The amount of investment that qualifies for the credit is the full purchase price for property in the 5-year, 10-year, 15-year real property, or 15-year public utility property class under ACRS. For 3-year recovery property under ACRS, only 60-percent of the purchase price is qualified investment. Qualified investment in property that is not eligible property under ARCS is based on the estimated useful life of the property. For property with a useful life of at least 7 years, the full purchase price is qualified invest-

[1] With exceptions, investments eligible for the credit include eligible property under ACRS and depreciable or amortizable property having a useful life of 3 years or more and include: (1) tangible personal property; (2) other tangible property (not including a building or its components) used as an integral part of (a) manufacturing, (b) extraction, (c) production or (d) furnishing of transportation, communications electrical energy, gas, water or sewage disposal services; (3) elevators and escalators; (4) research facilities and facilities for the bulk storage of fungible commodities and (5) single purpose agricultural structures.

ment. Two-thirds of the investment in property with a useful life of 5 to 7 years qualifies for the credit. For property with a useful life of 3 to 5 years, one-third of the investment qualifies for the credit.

In 1978, the credit was extended to qualified rehabilitation expenditures for nonresidential buildings. In 1981, the used property limitation was increased to $125,000 per year for taxable years 1981–1984, and $150,000 per year for taxable years beginning after 1984. Also, the rehabilitation credit was modified to provide a three-tier system of 15-, 20- and 25-percent credits.

For taxable years beginning in 1981 through 1984, only $125,000 of investment in used property qualifies for the credit in one year. For taxable years beginning after 1984, $150,000 of investment in used property qualifies for the credit in one year. For taxable years, before 1981, the used property limitation was $100,000.

For taxable years ending in 1982 and thereafter, the maximum credit that can be claimed in any one year is $25,000 plus 90 percent of the tax liability over $25,000. Any ususued amount of the credit can be carried back 3 years and carried forward 15 years. For pre-1974 carryovers a 7-year period was allowed. Use of the credit generally does not reduce the cost of an asset for purposes of calculating depreciation. The 15- and 20-percent credits for qualified rehabilitation expenditures, however, do reduce the building's depreciable basis.

In 1981, an at-risk limitation was imposed on the allowance of the tax credit. For individuals, subchapter S corporations, and certain closely held corporations, the investment credit is allowed only to the extent the investment in eligible property is at-risk. An exception is provided for limited nonrecourse financing by certain third-party lenders. Another exception is provided for certain energy property.

Impact

The credit has two effects. First, it reduces the cost of capital and, therefore, can turn an unprofitable investment into a profitable one (or a profitable one into a more profitable one). Assume that an investor requires a 15-percent rate of return to undertake an investment project. A machine which costs $1,000 and provides an annual return of $135 does not meet the 15 percent target. However, since a 10-percent ITC reduces the net cost of the machine to $900, the $135 annual return with the credit meets the 15 percent standard (15 percent of $900=$135). Second, it increases the recipient's cash flow.

While noncorporate businesses and individual investors benefit from the credit, over 80 percent of the credit accrues to corporations. Since the credit is directly related to investment in durable equipment, much of the direct benefit is concentrated in manufacturing and utilities.

According to 1977 tax data, 74 percent of the ITC was claimed by corporations with assets of $250 million or more. Two major industry categories account for 80 percent of the credit: manufacturing (42 percent), and transportation, communication, electric, gas, and sanitary services (38 percent).

For some firms, e.g., public utilities, the credit on an investment may exceed the company's tax liability. Instead of purchasing the property, the firm may find it profitable to lease the equipment from a bank that is able to obtain full benefit from the credit. Securities and Exchange Commission data indicate substantial use of the credit by banks through leasing arrangements.

Several studies have produced little evidence that suggests the past changes in the application of the credit have been effective as *short-run* business cycle stabilization tools. Other studies have produced conflicting evidence as to the *long-run* effectiveness of the credit in stimulating investment which increases the rate of capital accumulation and economic growth.

Rationale

Originally adopted as part of the Revenue Act of 1962, the credit was intended to stimulate investment and economic growth. The credit was also justified as a means of increasing the ability of American firms to compete abroad and of compensating for the effect of inflation on capital replacement. The credit was modified in 1964, suspended in September 1966, restored in March 1967, repealed in April 1969, reenacted in August 1971, temporarily liberalized in March 1975 until the end of 1976, and in 1976, extended at the liberalized rate through 1980.

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AMORTIZATION OF MOTOR CARRIER OPERATING RIGHTS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982		120	120
1983		70	70
1984		70	70
1985		55	55
1986		20	20
1987			

Authorization

Section 266 of the Economic Recovery Tax Act of 1981.

Description

An ordinary deduction is allowed ratably over a 60-month period for taxpayers who held one or more motor carrier operating authorities on July 1, 1980. The amount of the deduction is the total adjusted bases of all motor carrier operating authorities held by the taxpayer on July 1, 1980, or acquired after that date under a binding contract in effect on that date. The 60-month amortization period begins July 1, 1980, or, at the taxpayer's election, with the first month of the taxpayer's first taxable year beginning after July 1, 1980. The bases of the operating authorities are reduced by the amount of the deduction allowed.

Under regulations to be prescribed by the Secretary, the holder of an authority on July 1, 1980, may elect to allocate additional basis to the operating authority. This allocation of additional basis may be made if the operating authority was held by a corporation when such corporation was directly or indirectly acquired by another corporation on or before July 1, 1980. In that case, if the acquiring corporation had received the authority through one or more corporate liquidations immediately following the stock acquisition, a portion of the acquiring corporation's stock basis in an acquired corporation may have been allocable to the operating authority under section 334(b)(2). Under regulations, any basis that would have been allocable to the operating authority under section

334(b)(2) may be allocated to the operating authority by the holder of the authority on July 1, 1980.

Impact

The deduction of the basis of motor carrier operating rights held on July 1, 1980, was enacted to reduce the tax liability of, and thereby provide some Federal compensation to, motor carriers who lost substantially all the value of such operating rights under the deregulation effects of the Motor Carrier Act of 1980.

Rationale

Since 1935, until enactment of the Motor Carrier Act of 1980, motor carrier operating rights were granted by the Interstate Commerce Commission only if the services to be provided under the authority was, or would be, required by the public convenience and necessity. Businesses with an existing authority could intervene to show that the proposed service was not, or would not be, required by the public convenience or necessity. Thus, existing operators had substantial protection against competition. Persons wishing to enter the motor carrier business or expand an existing business often found it easier to purchase an existing business and its operating authority. Substantial amounts were paid for these operating authorities.

Under the Motor Carrier Act of 1980 (Public Law 96-296) which was enacted in July 1980, restrictions on entry into the motor carrier industry were lessened, thereby substantially reducing the value of existing motor carrier operating authorities. In many cases, these operating authorities represented a substantial part of a taxpayer's equity in its business and often were pledged as collateral to raise capital. However, although deregulation of the industry substantially reduced the value of operating authorities, no loss was allowable for income tax purposes. A loss is allowed under section 165 only if the property is sold, abandoned, or otherwise disposed of. Absent such a disposition, no loss is allowed for a mere decline in the value of property. Several court decisions have held that a decline in value like that of the operating authorities was not a deductible loss.

In 1981, as part of the Economic Recovery Tax Act, Congress concluded that the unique circumstances of the deregulation of the motor carrier industry made necessary some form of relief. Therefore, taxpayers were permitted an ordinary deduction for their investment in operating authorities held on July 1, 1980.

Further Comment

Several issues are raised by the deduction for motor carrier operating authorities. First, it has been questioned whether this provision suggests that other taxpayers are entitled to similar relief in the event of Federal deregulation of other industries. Second, assuming that some form of compensation is appropriate in some instances of deregulation, the question is raised whether tax relief is the appropriate form of compensation. It has been argued that the loss of the value of a business should be compensated on the basis

of the value that is lost, rather than the amount of the taxpayer's investment in the business. This issue raises the question whether the Federal government should treat losses due to deregulation as if they were tax losses or should treat them as injuries to private citizens by the government, which should be compensated by the government.

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DEFERRAL OF TAX ON SHIPPING COMPANIES

[In millions of dollars]

Fiscal Year	Individuals	Corporations	Total
1982		65	65
1983		85	85
1984		80	80
1985		50	50
1986		40	40
1987		35	35

Authorization

46 U.S.C. Section 1177 (§ 607 of the Merchant Marine Act of 1936 as amended) and section 46(g) of the Internal Revenue Code.

Description

U.S. operators of vessels in foreign, Great Lakes, or noncontiguous domestic trade or in U.S. fisheries may establish a capital construction fund (CCF) in which they may deposit income earned by the vessels. Such deposits are deductible from taxable income, and income tax on earnings of deposits in the CCF is deferred.

When such tax-deferred deposits and their earnings are withdrawn from a CCF, no tax is paid if the withdrawal is used for qualifying purposes, such as to construct or acquire a new vessel or to pay off the indebtedness of a qualifying vessel. The tax basis of the vessel (usually its cost to the taxpayer) on which the operator's depeciation is computed is reduced by the amount of such withdrawal. Thus, over the life of the vessel, tax depreciation will be reduced and taxable income will be increased by the amount of such withdrawal, thereby reversing the effect of the deposit. However, since gain on the sale of the vessel and income from the operation of the replacement vessel may also be deposited into the CCF, the tax deferral may be extended indefinately.

Only withdrawals for purposes other than for construction, acquisition, or payment on indebtedness of a qualifying vessel are taxed at the time of withdrawal, subject to an interest charge for the period during which tax was deferred.

An investment tax credit of one-half the regular credit is allowed for tax deferred amounts withdrawn from CCF's that are used to purchase, construct, or reconstruct qualified vessels.

Impact

Since the inception of this program in the fall of 1971, $1.2 billion has been deposited into CCF's, and $700 million withdrawn.

Rationale

The provision is designed to stimulate American shipbuilding and to recapture some of the foreign yard construction now being done for U.S. companies.

Although tax subsidies of various types have been in existence since 1936, the coverage of the subsidies was expanded substantially by the Merchant Marine Act of 1970.

Prior to the Tax Reforn Act of 1976, it was unclear whether the investment tax credit was available for eligible vessels financed in whole or in part out of funds withdrawn from a CCF. The 1976 act specifically provided that a minimum investment credit equal to 50 percent of the withdrawal applied to purchase, construct, or reconstruct qualified vessels, was available in 1976 and subsequent years.

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EXCLUSION OF INTEREST ON STATE AND LOCAL GOVERNMENT IDB's FOR MASS TRANSIT

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	5	10	15
1983	15	35	50
1984	30	65	95
1985	40	85	125
1986	45	90	135
1987	45	90	135

Authorization

Sections 103(b); 168

Description

The Economic Recovery Tax Act of 1981 provides that interest on obligations of a State or local government is exempt from Federal income tax if substantially all of the proceeds of the obligations are used to provide qualified mass commuting vehicles. The act defines such vehicles to mean any bus, subway car, rail car, or similar equipment which is leased to a mass transit system that is wholly owned by one or more governmental units—or agencies or instrumentalities of such units—and that is principally used by the mass transit system in providing mass commuting services to the general public.

The act also defines qualified leased property to include qualified mass commuting vehicles that are financed in whole or in part by obligations the interest on which is excludable from income under section 103(a). Mass commuting vehicles qualify even though the property is used by a tax-exempt organization or governmental unit in an exempt function and, thus, does not qualify for the investment credit. However, only cost recovery allowances attributable to qualified mass commuting vehicles, and not investment credits, may be transferred under a safe harbor lease.

In regulations, the Internal Revenue Service has stated that for tax purposes, a lease of mass transit vehicles may not cover any portion of costs paid for by a Federal grant for the property.

Impact

State and local governments or their transit authorities are able to share in the cost-reducing benefits of the accelerated cost recovery system through the sale and leaseback provisions in the act.

Rationale

The prospect of reductions in Federal grants for mass transit capital equipment required alternative provisions. For the leasing provisions in another part of the 1981 act to apply effectively to mass transit equipment, it also was necessary to add to the list of exempt activities for which an industrial development bond could be issued. As a result of this act, industrial development bonds could be issued for mass transit vehicles used for commuting purposes as well as such mass commuting facilities as terminals.

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FIVE-YEAR AMORTIZATION FOR HOUSING REHABILITATION

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	55	35	90
1983	60	40	100
1984	70	45	115
1985	75	50	125
1986	80	60	140
1987	85	65	150

Authorization

Section 167(k).

Description

In lieu of capital cost recovery, certain expenditures incurred to rehabilitate low- or moderate-income rental housing may be amortized over 5 years using the straight-line method and no salvage value. This rapid amortization is permitted only for expenditures of $20,000 or less per rental unit ($40,000 per unit for rehabilitation conducted pursuant to a program under which tenants may purchase their units at a price that limits the profit to the seller). The writeoff is available only where, during a period of 2 consecutive years, expenditures exceed $3,000 per unit. The use of 5-year amortization, instead of the 15-year recovery normally allowed, benefits the taxpayer by effectively deferring current tax liability.

Example

Assume a taxpayer spends $20,000 on structural rehabilitation of low- or moderate-income rental housing. Without the amortization provision, the deduction in the first year (using the double declining balance method of computing depreciation over the normal 15-year period) would be: 200 percent$\times$1/15$\times$$20,000=$2,667.

In the second year, the deduction would be: 200 percent$\times$1/15$\times$$17,333=$2,311.

The deductions would continue in smaller amounts over the remaining 13 years.

With 5-year amortization, one-fifth of the amount ($4,000) would be deducted each year for 5 years. Afterward, no additional deductions for amortization or recovery would be taken.

Impact

The tax benefits accrue to investors in projects to rehabilitate low- and moderate-income housing. Even though the properties in question may not be currently earning income, the rapid amortization may be deducted against other income and thus may provide a tax shelter for totally unrelated income. Low-income renters benefit only to the extent that rehabilitated units rent for less than new units of comparable quality, or to the extent that more units are rehabilitated than would be otherwise. The very small amount of evidence available does not indicate a flowthrough of tax benefits to the renters.

Rationale

This provision was adopted as part of the Tax Reform Act of 1969 as a temporary provision to stimulate rehabilitation of low- and moderate-income housing. It was subsequently extended for 1 year by Public Law 93-625 (Jan. 3, 1975). Although it expired December 31, 1975, a retroactive reinstatement through 1977 was added in the Tax Reform Act of 1976, which slightly liberalized the provision as well. The provision was extended again in November 1977 on a temporary basis through the end of 1978 and extended again in 1980 through the end of 1983. The higher limit of $40,000 on some amortizable expenditures per unit was enacted in 1981.

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INVESTMENT CREDIT FOR REHABILITATION OF STRUCTURES OTHER THAN HISTORIC STRUCTURES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	80	455	535
1983	90	505	595
1984	100	570	670
1985	115	640	755
1986	130	725	855
1987	145	825	970

Authorization

Section 48(g).

Description

Amounts spent on substantial rehabilitations of nonresidential buildings over 40 years old qualify for a tax credit of 20 percent and on nonresidential buildings over 30 years old for a credit of 15 percent. In order to qualify for the credit, at least 75 percent of the exterior walls must be retained, and the amount spent on the rehabilitation must exceed the greater of $5,000 or the initial adjusted basis of the building. Amounts recovered through these tax credits cannot be deducted through capital cost recovery, that is, there must be a "basis adjustment." For instance, an owner who takes the 20 percent credit for $100,000 spent on rehabilitating a 50-year old factory can only recover the remaining $80,000 ($100,000 − $20,000). In addition, owners are restricted to a straight-line recovery method for rehabilitation expenditures, and part of the credit is recaptured if the property is sold within the first 5 years. These credits effectively allow taxpayers to defer tax liability and erase some tax liability.

Example

An owner of a 50-year old factory who spends $100,000 on rehabilitation is entitled to a credit of $20,000 in the first year and

equal deductions for capital cost recovery in each of the following 15 years of: ($100,000 − $20,000) × 1/15 = $5,333.

If the owner is in the 50 percent tax bracket, the tax savings in the first year are $22,666 ($20,000 tax credit plus deductions worth $2,666 = (.5) × ($5,333)).

Had the owner chosen not to take the credit, the recovery deduction in the first year (using the 150 percent declining balance method of cost recovery over a 15-year period) would have been: ($100,000) × (150 percent) × 1/15 = $10,000 for a tax savings of $5,000.

In the second year, it would have been: ($90,000) × (150 percent) × 1/15 = $9,000 for a tax savings of $4,500.

Impact

These provisions encourage business to renovate rather than relocate. They reduce the cost of rehabilitation and therefore can turn unprofitable rehabilitation into profitable rehabilitation and make rehabilitation more profitable than new construction.

Rationale

The 15- and 20-percent credits were enacted in 1981 and replaced a 10-percent credit that had been available since 1978 for rehabilitations of nonresidential buildings over twenty years old. The Congress enacted the larger credits at the same time that it significantly shortened recovery periods in general, because it wanted to counteract any tendency on the part of the general provisions to encourage firms to relocate and build new plants. Relocation can cause hardship to the families of workers and communities left behind that the firm would not take into account in its decision.

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EXCLUSION OF SCHOLARSHIP AND FELLOWSHIP INCOME

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	465		465
1983	415		415
1984	375		375
1985	395		395
1986	410		410
1987	435		435

Authorization

Section 117.

Description

Generally, individuals may exclude from taxable income amounts received as scholarships or fellowships. The exclusion includes amounts received to cover such incidental expenses as travel, research, clerical assistance, or equipment, but does not apply to any amount received as payment for teaching, research, or similar services. The amount that degree candidates may exclude is unlimited. Scholarships and fellowships for nondegree candidates may be excluded only if the grantors meet certain requirements; further, the amount that they may exclude is limited.

Impact

The value of the tax benefit received by each recipient of a tax-exempt scholarship or fellowship grant is small in many cases because grants are of modest amounts and the recipients have little or no tax liability.

Rationale

Prior to the Internal Revenue Code of 1954, scholarships were included in income unless the taxpayer could show that the grant was a gift. This treatment was considered to lack uniformity. The ostensible purpose of the exclusion was to make treatment of taxpayers consistent and uniform. The only amendment to this sec-

tion, made in 1961 (Public Law 87-256), expanded the category of qualifying grantors of nondegree candidates' scholarships and fellowship grants.

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EXCLUSION OF INTEREST ON STATE AND LOCAL STUDENT LOAN BONDS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	30	60	90
1983	45	95	140
1984	65	135	200
1985	85	175	260
1986	105	220	325
1987	125	260	385

Authorization

Section 103(a)(2).

Description

State and local agencies can issue bonds and use the proceeds to make or purchase student loans. Nearly all of the student loans so financed are guaranteed student loans (GSL's), on which the Federal Government pays a share of the interest and the student pays the remainder. The "special allowance payments" made by the Federal Government are not included in the yield of the loans for purposes of determining whether the bonds violate the arbitrage rules governing all tax-exempt bonds. These rules generally limit the yield on the loans to no more than 1.5 percentage points above the yield on the bonds, to prevent issuers from profiting from tax-exempt bonds. Because the issuers of student loan bonds can raise funds at a lower cost than banks can, loans financed with the proceeds of tax-exempt bonds earn only half the special allowance other loans do (chiefly those financed by banks). The student loans backing these bonds are guaranteed by State agencies which are reimbursed by the Federal Government for defaulted loans. Tax-exempt bonds have also financed parent loans and loans to medical and dental students.

Impact

These bonds may increase somewhat the availability of student loans, but they do not lower the interest rate to students since this

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is set by Federal law. They create a secondary market for student loans in much the same way the Student Loan Marketing Association does.

The bonds first came into widespread use in the early 1970's. By 1981, student loan bonds had been issued in 21 states and the District of Columbia. A total of $800 million of these bonds was issued in 1981.

Rationale

Authority for local nonprofit corporations to issue tax-exempt bonds for student loans was granted in the Tax Reform Act of 1976. That Act also excluded the special allowance from arbitrage yield calculations, probably because of concern that the administrative costs of student loan programs would exceed the 1.5 percentage point spread generally allowed. Because states subsequently profited from this provision, the Education Amendments of 1980 reduced the special allowance on student loans financed by tax-exempt bonds to half that of other student loans.

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PARENTAL PERSONAL EXEMPTION FOR STUDENTS AGE 19 OR OVER

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	995	.....	995
1983	900	.....	900
1984	845	.....	845
1985	835	.....	835
1986	845	.....	845
1987	855	.....	855

Authorization

Section 151(e).

Description

A taxpayer is allowed to deduct $1,000 as an exemption for each dependent. A person with gross income in excess of $1,000 may not be claimed as a deper lent unless that person is the child of the taxpayer and is either (a) less than 19 years of age or (b) a full-time student. Unless support is provided by several taxpayers, a person is a dependent only if the taxpayer claiming him as a dependent provided more than one-half of the person's support.

Impact

This provision benefits families with tax liability and with children who are students and have earnings. The value of each $1,000 personal exemption deduction is $500 for families with the highest marginal tax rate of 50 percent and $140 for those with the lowest marginal rate. No relief is available to the parents of students who provide more than one-half of their own support. Therefore, parents are aided by this dependency exemption if their student-children do not rely on their earnings or other income to provide a majority of their support.

Rationale

A personal exemption for dependents was first provided by the Revenue Act of 1918, apparently to provide some tax relief for par-

ents supporting young children or students. The definition of a dependent was revised over the years, and a gross income test was added in 1944, disallowing the deduction for parents if the dependent earned more than a specified amount. The 1954 revision of the Internal Revenue Code eliminated the gross income test for dependent children under the age of 19 and dependent children of any age who were students. The main reason for the change was to avoid the "notch" problem that resulted when a dependent's earnings were close to the exemption amount; an extra few dollars in earnings could deprive the parents of the exemption, costing them hundreds of dollars in extra taxes. Except for increases in the amount of the exemption to $1,000, this provision has been unchanged since 1954.

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EXCLUSION OF EMPLOYEE MEALS AND LODGING (OTHER THAN MILITARY)

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	655	.....	655
1983	680	.....	680
1984	725	.....	725
1985	795	.....	795
1986	870	.....	870
1987	945	.....	945

Authorization

Section 119.

Description

Employees exclude from income the value of meals and lodging furnished by the employer on his business premises and for his convenience; the lodging must be required as a condition of employment.

Impact

Meals and lodging furnished by the employer may, in certain cases, constitute a very large portion of the employee's compensation (e.g., in the case of a live-in housekeeper or an apartment resident manager). The value to the employee of such in-kind income in some cases may be difficult to establish. For example, the lodging may simply duplicate rather than substitute for private quarters. The value of the exclusion depends on the value of the income in-kind and the tax bracket of the employee. To the extent that money wages are lower as a result of the tax benefit, employment is subsidized in occupations that involved this type of income in-kind.

Rationale

The convenience-of-the-employer rule has been in the tax regulations since 1918, presumably in recognition of the problems discussed above. Treatment of such benefits was handled through reg-

ulation and court decisions until 1954. The regulations suggest that immediately prior to the 1954 act, meals and lodging that were in the nature of compensation (i.e., taken into account in computing salary) were included in income even if they were for the convenience of the employer. The specific statutory language was adopted to end the confusion regarding the tax status of such payments by precisely defining the conditions under which such meals and lodgings were taxable.

Further Comment

The difficulty in many cases in valuing these benefits is cited as a major argument against taxing them. On the other hand, this argument is challenged by others who cite the fact that a value is placed on these payments under many State welfare laws.

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EMPLOYER EDUCATIONAL ASSISTANCE

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	40		40
1983	40		40
1984	20		20
1985			
1986			
1987			

Authorization

Section 127.

Description

An employee may exclude from gross income amounts paid by the employer for educational assistance pursuant to a qualified educational assistance program. Amounts that may be excluded by an employee include amounts paid by the employer for tuition, fees, and similar payments, as well as the cost of books, supplies, and equipment.

For a program to qualify as a qualified educational assistance program, the employees must not be able to choose taxable benefits in lieu of educational benefits. Furthermore, an educational assistance program must not discriminate in favor of employees who are officers, owners, or highly compensated (or their dependents). Unless extended, the benefits of this provision will not apply to any employees in taxable years beginning after December 31, 1983.

Impact

Employer-provided education may constitute a significant portion of the employee's compensation. The value of the exclusion depends upon the amount of educational expenses furnished to the employee and the tax bracket of the employee.

Rationale

Prior to the enactment of the exclusion in 1978, the treatment of employer-provided educational assistance added to the complexity

of the tax system and sometimes acted as a disincentive to continuing education. The complexity resulted from the fact that when an employee received educational assistance from an employer, the assistance was treated as wages to the employee and a case-by-case determination of whether the employee could deduct the assistance as job-related education was required. The exclusion allows certain employees, who otherwise might be unable to do so, to continue their education.

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EXCLUSION OF CONTRIBUTIONS TO PREPAID LEGAL SERVICES PLANS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	20		20
1983	25		25
1984	25		25
1985	10		10
1986			
1987			

Authorization

Sections 120 and 501(c)(20).

Description

Amounts contributed by an employer to a qualified group legal services plan for employees, as well as any services received by an employee or any amounts paid to an employee under such a plan as reimbursement for legal services for the employee, are excluded from the employee's income. This exclusion applies to plans established to provide personal legal services for employees, their spouses, and their dependents through prepayment of, or advance provision for, legal fees. Sole proprietors and partners are considered employees for purposes of the exclusion. Plans must be organized through tax-exempt organizations or trusts, or established through insurance companies. To qualify, plans must be nondiscriminatory with respect to enrollment and benefits.

This provision applies to taxable years ending before January 1, 1985.

Impact

The tax treatment afforded these plans is similar generally to that provided group life insurance plans and accident and health plans set up by employers for their employees. The value of the exclusion increases with increases in the marginal tax rate of the employee. Group legal programs and similar arrangements were not widely used prior to enactment of these tax provisions in 1976. Al-

though no comprehensive statistics are available, indications are that the number of these plans has grown as a result of the tax incentive.

Rationale

This tax treatment of group prepaid legal services plans was adopted in 1976 to grant taxpayers some relief from the high cost of legal fees, and to promote the adoption of such plans by employers and employees, Congress believed it was desirable to increase the availability of legal services to middle-income taxpayers whom they considered to be the most under-represented economic group in terms of legal services. Higher income taxpayers generally can afford to pay their own legal expenses, while lower income persons may have access in some areas to publicly supported legal aid services.

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EXCLUSION FOR EMPLOYER-PROVIDED CHILD CARE

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982			
1983	10		10
1984	25		25
1985	55		55
1986	85		85
1987	120		120

Authorization

Section 129.

Description

Payments by an employer for dependent care assistance provided to an employee are excluded from the employee's gross income, if the assistance is provided under a plan which meets certain conditions. These conditions include eligibility conditions which do not discriminate in favor of owners and highly compensated individuals, and reasonable notification of the availability of the benefits to eligible employees.

Impact

The exclusion provides an incentive for employers to provide, and employees to receive compensation in the form of dependent care assistance rather than cash. The assistance is free from income tax while the cash is subject to it. As is the case with all deductions and exclusions, this incentive is higher for taxpayers in high tax brackets than those in low tax brackets.

Rationale

This provision, enacted in the Economic Recovery Tax Act of 1981, was intended to provide an incentive for employers to become more involved in the provision of dependent care for their employees.

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TAX CREDIT FOR ESOP's

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982		1,005	1,005
1983		1,095	1,095
1984		1,245	1,245
1985		1,830	1,830
1986		2,320	2,320
1987		2,460	2,460

Authorization

Sections 44G, 46(a)(2)(A), 48(n), 401(a), and 409A.

Description

A corporation is allowed an additional investment tax credit of up to one percent of qualifying investment if the corporation contributes an equivalent amount of its own stock to a trust forming part of a tax credit ESOP for the benefit of its employees. In addition, up to one-half percent of extra investment tax credit is allowed if the corporation contributes the extra amount to the tax credit ESOP and the corporation's extra contribution is matched by employee contributions. The additional investment tax credit allowed for contributions to a tax credit ESOP terminates with respect to qualifying investments made after December 31, 1982.

For taxable years ending after December 31, 1982, in lieu of the additional investment tax credit, an electing employer is allowed an income tax credit for contributions to a tax credit ESOP limited to a prescribed percentage of the aggregate compensation of all employees under the plan. For compensation paid or accrued in calendar years 1983 and 1984, the tax credit is limited to one-half of one percent. With respect to compensation paid or accrued in 1985, 1986, and 1987, the limit is three-quarters of one percent. No credit is provided with respect to compensation paid or accrued after December 31, 1987.

Tax credit ESOP's are subject to many of the rules that govern pension plans in general, but are also subject to special rules more favorable to employees than are pension plans generally. For example, in contrast to pension and profit sharing plans which may

provide deferred vesting, benefits under tax credit ESOP's immediately vest in employees.

Stock held under a tax credit ESOP generally must remain in the trust for seven years, after which it can be distributed to the employees.

Impact

Since a corporation is granted a credit equal to its contribution to a tax credit ESOP, the contribution has no cost to the corporation and is financed entirely by the Federal Government. By comparison, contributions to regular pension, profit-sharing, or stock bonus plans are made directly by the employer and resemble wage costs. Furthermore, in contrast to pension plans in general, only corporate employers are entitled to this tax credit. Employees of sole proprietors and partnerships cannot benefit.

Even where provided in the form of an investment credit, the ESOP credit has no direct incentive effect on investment since the value of the additional tax credits must be placed in trust for the employees. The ESOP provisions can provide a relatively minor direct benefit to corporations which can raise cash by issuing their own stock for transfer to ESOP's without the costs of a public offering. In cases in which annual ESOP stock benefits are very substantial for individual employees, the benefits may partially offset salary payments.

Rationale

A temporary additional investment tax credit for contributions to employee stock ownership plans first was provided by the Tax Reduction Act of 1975 to encourage the growth of these types of plans. The avowed purpose was to provide funds for the purchase of corporate stock by employee trusts allowing employees to share in the ownership of corporate capital and in the growth and profitability of the employer. However, because of the temporary nature of the tax credit and rules which could have resulted in some instances in corporations paying for contributed stock themselves, few plans were established before the 1976 Tax Reform Act. These plans became more widespread with the revisions in the Tax Reform Act of 1976 which extended and expanded the investment-based credit in general and which eliminated any risk of costs of the trusts being borne by employers.

In the Economic Recovery Tax Act of 1981, the payroll-based tax credit was substituted for the investment-based credit to encouraged labor-intensive corporations to establish tax credit ESOP's.

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(500) Education, Training, Employment, and Social Services

DEDUCTIBILITY OF CHARITABLE CONTRIBUTIONS

(1) Educational Institutions

(2) Health Institutions

(3) Other Than Educational and Health Institutions

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals			Corporations			Total		
	Educational	Health	Other	Educational	Health	Other	Educational	Health	Other
1982	580	1,165	7,960	315	195	385	895	1,360	8,345
1983	560	1,120	7,635	365	225	450	925	1,345	8,085
1984	570	1,150	7,840	445	275	555	1,015	1,425	8,395
1985	660	1,325	9,045	515	320	635	1,175	1,645	9,680
1986	830	1,660	11,335	550	340	680	1,380	2,000	12,015
1987	860	1,725	11,790	575	355	710	1,435	2,080	12,500

Authorization

Sections 170 and 642(c).

Description

Subject to certain limitations, charitable contributions may be deducted by individuals, corporations, and estates and trusts.

The contributions must be made to specific types of organizations listed in Code Section 170(c). This includes charitable, religious, educational, and scientific organizations, and Federal, State, and local governments.

Individuals who itemize may deduct qualified contributions of up to 50 percent of their adjusted gross income (AGI). However, the deduction for gifts of appreciated property is limited to 30 percent of AGI. For contributions in either cash or property to private foundations that do not meet specified requirements, the deduction is limited to 20 percent of AGI.

There is a special provision for nonitemizers covering only the tax years 1982 through 1986. Beginning in tax year 1982 and for tax year 1983, individuals who do not itemize may take a deduction

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equal to 25 percent of the first $100 of charitable contributions. For tax year 1984, a deduction of 25 percent of the first $300 of contributions is permitted. During 1985, 50 percent of all contributions will be deductible. For 1986, all charitable contributions are deductible. It should be noted that during the years in which a contribution cap is applicable, the cap is not doubled for those taxpayers filing joint returns. This special provision for nonitemizers is scheduled to expire in 1987.

In the case of a corporation, the limitation on the amount of charitable contributions which may be deducted is 10 percent of taxable income (with some adjustments).

Impact

The deduction for charitable contributions reduces tax liability, and thus makes the net cost of contributing less than the amount of the gift. In effect, the Federal Government provides the donee with a matching grant which, per dollar of contribution, increases in value with the donor's tax bracket. Thus, a taxpayer in the 70 percent bracket who itemizes deductions can contribute $100 to a charitable organization at a net cost of $30, while one in the 20 percent bracket can contribute the same amount at a net cost of $80. An individual who takes the standard deduction or a non-taxpayer receives no benefit from the provision.

Types of contributions may vary substantially among income classes. Contributions to religious organizations are far more concentrated at the lower end of the income scale than contributions to hospitals, the arts, and educational institutions, with contributions to other types of organizations falling between these levels. However, the volume of donations to religious organizations is greater than to all other organizations as a group. The volume of giving to educational and health institutions is relatively low.

Organizations that receive the contributions (and their clients) benefit from this provision to the extent it increases charitable giving. Empirical studies have not reached a consensus as to how much the deduction encourages charitable contributions and how the deduction affects the composition of contributions. Tentative conclusions are that the deduction increases charitable giving by more than the foregone Treasury revenue, and that it favors educational and hospital contributions relatively more than religious, health and welfare, and other donees. A tax credit or a matching grant program outside the tax system of equal cost would be expected to reduce the contributions to educational and hospital organizations, while increasing them for other recipients.

Rationale

This deduction was added on the Senate floor in 1917. Senator Hollis, the sponsor, argued that the war and high wartime tax rates had an adverse impact on the flow of funds to charitable organizations. He preferred a tax deduction to a direct Government subsidy. The deduction was extended to estates and trusts in 1918, and to corporations in 1935.

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CREDIT FOR CHILD AND DEPENDENT CARE EXPENSES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	1,350		1,350
1983	1,465		1,465
1984	1,515		1,515
1985	1,660		1,660
1986	1,820		1,820
1987	2,030		2,030

Authorization

Section 44A.

Description

A taxpayer who maintains a household is allowed a tax credit for employment-related expenses incurred for the care of a dependent child, a disabled dependent, or a disabled spouse. The maximum credit is 30 percent of expenses up to $2,400 (for a maximum credit of $720) annually for one qualifying individual and up to $4,800 (for a maximum credit of $1,440) annually for two or more qualifying individuals, in the case of taxpayers with adjusted gross income of $10,000 or less. The rate of the credit is reduced by one percentage point for each $2,000 of income, or fraction thereof, above $10,000 until the lowest rate (20 percent) is reached for taxpayers with incomes above $28,000.

Employment-related expenses that are incurred outside the taxpayer's household may be taken into account if they are for the care of a physically or mentally incapacitated spouse or dependent of the taxpayer who regularly spends at least eight hours each day in the taxpayer's household, or if they are for the care of a dependent of the taxpayer who is under the age of 15. Expenses that are incurred for services provided by a dependent care center may be taken into account only if the center complies with all applicable State and local laws and regulations. The credit is permitted for payments to relatives of the taxpayer regardless of whether they live in or outside the taxpayer's household, provided they are not dependents of the taxpayer.

Impact

The credit benefits qualified taxpayers with sufficient tax liability to take advantage of it, without regard to whether or not they itemize their deductions. The credit does not benefit persons with incomes so low that they have no tax liability.

Because the credit rate phases down from 30 to 20 percent as incomes rises from $10,000 to $28,000, the credit targets greater benefits toward low- and middle-income taxpayers.

Rationale

The deduction for child and dependent care services first was enacted in 1954. The allowance was limited to $600 per year and was phased out for families with income between $4,500 and $5,100. The intent of the provision was to provide for the deduction of expenses comparable to an employee's business expenses in cases where taxpayers must incur such expenses.

The provision was made more generous in 1964, and was modified in 1971. Several new justifications were specified for the provision in 1971, including encouraging the hiring of domestic workers, encouraging the care of incapacitated persons at home rather than in institutions, providing relief to middle income taxpayers as well as low income taxpayers, and providing relief for employment-related expenses of household services as well as for dependent care. Thus, there was a departure from the earlier intent that only "essential" expenditures for such services should be deductible.

The Tax Reduction Act of 1975 substantially increased the income limits for taxpayers who could claim the deduction.

In 1976, the deduction was replaced by a nonrefundable credit. Congress believed that (1) such expenses should be viewed as a cost of earning income for *all* taxpayers and that it was wrong to deny the benefits to those taking the standard deduction, (2) the tax credit would provide relatively more benefit than the deduction to taxpayers in the lower brackets, (3) the prior rules governing married couples, divorced and separated persons, and payments to relatives were unduly restrictive, and (4) computation of the deduction was too complex.

The Revenue Act of 1978 eliminated the requirement that child care services performed by relatives must constitute "employment" within the meaning of the social security tax definition in order to qualify as creditable expenses.

In 1981, the provision was converted into a sliding-scale credit that phases down from 30 to 20 percent as income rises from $10,000 to $28,000. Moreover, the maximum amounts eligible for the credit were increased. The purpose of switching to a sliding-scale credit was to target the increases in the credit toward low- and middle-income taxpayers.

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TARGETED JOBS CREDIT

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	35	200	235
1983	10	65	75
1984	10	50	60
1985	5	30	35
1986		10	10
1987		5	5

Authorization

Section 44B, 50B, and 51.

Description

This provision provides a nonrefundable tax credit to employers who hire new employees from nine targeted groups. The credit equals the lesser of 50 percent of qualified wages or $3,000 in the first year of employment and the lesser of 25 percent or $1,500 during the second year. The targeted groups include:

(1) economically disadvantaged vocational rehabilitation referrals,
(2) economically disadvantaged youth,
(3) economically disadvantaged Vietnam-era veterans,
(4) SSI recipients,
(5) general assistance recipients,
(6) economically disadvantaged cooperative education, students,
(7) economically disadvantaged former convicts,
(8) individuals involuntarily terminated from the CETA jobs program, and
(9) AFDC recipients.

Impact

Since no more than $6,000 of wages during either the first or second year of employment may be taken into account with respect to any individual, the maximum credit per individual is $3,000 in the first year of employment and $1,500 in the second year of employment. The employer's deduction for wages is reduced by the

amount of the credit (determined without regard to the tax liability limitation on the credit). Thus, for an employer who hires an eligible employee who earns $6,000 in the first year of employment, the credit results in an actual tax reduction that ranges from $900 (for an employer in the 70-percent bracket) to $2,580 (for an employer in the 14-percent bracket). However, because all wages are deductible for employees who are not members of target groups, after-tax costs of the first $6,000 of wages paid to an employee would range from $1,800 (for an employer in the 70-percent bracket) to $5,160 (for an employer in the 14-percent bracket) if the credit were not available. Thus, the credit provides a 50-percent reduction in the after-tax costs of the first $6,000 of wages paid to target group employees in the first year of employment, regardless of the employer's tax bracket.

Data from March 1979 through 1980 under a previous version of the credit which did not include AFDC recipients or CETA workers and included all cooperative education students showed that nearly half of the 411,000 certifications were cooperative education students. Economically disadvantaged youth accounted for 150,000 certifications, and the rest were just under 20,000 each for Vietnam veterans, exconvicts, and the handicapped. Only 9,200 were general assistance or SSI recipients.

Though there is no comprehensive information, it is expected that much of the credit goes to labor intensive industries and especially those which hire large numbers of minimum wage workers, such as the fast food industry.

Rationale

The credit is designed to increase employment especially among categories of workers who experience the greatest difficulty in finding jobs. It reduces the negative impact of the minimum wage upon employment of economically disadvantaged youth, and it encourages employers to invest time and effort in training those previously unemployable for work.

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DEDUCTION FOR TWO-EARNER MARRIED COUPLES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	705		705
1983	3,980		3,980
1984	7,030		7,030
1985	7,980		7,980
1986	8,945		8,945
1987	10,070		10,070

Authorization

Section 221.

Description

Two-earner married couples who file joint returns are allowed a deduction from gross income equal to 10 percent (5 percent in 1982) of the qualified earned income of the lesser earning spouse. The maximum deduction is $1,500 in 1982 and $3,000 thereafter. Taxpayers may claim this deduction even if they do not itemize their deductions.

Impact

This provision reduces the marriage penalty and in some cases increases the marriage bonus as shown below. The penalty or bonus equals the difference in tax liability for two-earner married couples between filing as one joint return or as two single returns.

MARRIAGE TAX PENALTY IN 1984 FOR TWO-EARNER COUPLES UNDER PRIOR LAW AND THE ECONOMIC RECOVERY TAX ACT OF 1981

Income of husband	Income of wife				
	$10,000	$20,000	$30,000	$50,000	$100,000
$10,000					
Prior law	$103	$185	$157	−$134	−$241
Act	−121	−84	−146	−512	−2,360

MARRIAGE TAX PENALTY IN 1984 FOR TWO-EARNER COUPLES UNDER PRIOR LAW AND THE ECONOMIC RECOVERY TAX ACT OF 1981—Continued

Income of husband	Income of wife				
	$10,000	$20,000	$30,000	$50,000	$100,000
$20,000					
Prior law	185	822	1,350	1,701	1,671
Act	−84	90	388	557	−837
$30,000					
Prior law	157	1,350	2,166	2,901	2,918
Act	−146	388	606	1,110	185
$50,000					
Prior law	−134	1,701	2,901	3,760	3,777
Act	−512	557	1,110	2,290	2,007
$100,000					
Prior law	−241	1,671	2,918	3,777	3,794
Act	−2,360	−837	185	2,007	3,390

NOTES:
The marriage bonus or penalty is the difference between the tax liability of a married couple and the sum of the tax liabilities of the two spouses had each been taxed as a single person. Marriage bonuses are negative in the table; marriage penalties are positive. It is assumed that all income is earned, that taxpayers have no dependents, and that deductible expenses are 23 percent of adjusted gross income and are allocated between spouses in proportion to income.
Computations under the act assume the rate schedules and two-earner couple deduction in effect in 1984.

Rationale

Both present and prior law only allow married couples to file a joint return even when it would be advantageous for them to file as single taxpayers because these couples usually pool their income and consume as a unit. Prior law upheld the principle of taxing couples with equal incomes equally. However, in the case of couples earning more than $20,000 and with the lesser earning spouse accounting for more than twenty percent of their combined earned income, the marriage penalty and marginal tax rates were quite high because the second income was taxed starting at the highest marginal tax rate on the first income. This proved to be a strong economic incentive against the second spouse going to work. It also undermined the family and the tax system by encouraging annual divorce and remarriage or avoidance of marriage altogether.

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DEDUCTION FOR ADOPTION EXPENSES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	10		10
1983	10		10
1984	10		10
1985	10		10
1986	10		10
1987	15		15

Authorization

Section 222.

Description

A taxpayer may take an itemized deduction for adoption expenses paid or incurred in connection with the adoption of a child with special needs *that is,* generally a child (1) who the State has determined cannot or should not be returned to the home of the natural parents, and (2) who, because of a specific factor or condition, cannot reasonably be expected to be adopted unless adoption assistance is provided under the Social Security Act. The maximum deduction with respect to the adoption of any one child is $1,500.

Impact

Adoption expenses which include adoption fees, court costs, attorneys fees, and other expenses related to the legal adoption of a child can be very high. These expenses, coupled with the problems of children with special needs, provide a major obstacle to the adoption of children with special needs. This provision reduces the financial burden in connection with the adoption of children with special needs.

Rationale

Adoption expenses traditionally have been considered as nondeductible personal expenses. The adoption expense deduction, which was enacted in 1981, is intended to reduce the obstacles in connec-

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tion with the adoption of children with special needs by reducing the financial burdens in connection therewith.

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EXCLUSION OF EMPLOYER CONTRIBUTIONS FOR MEDICAL INSURANCE PREMIUMS AND MEDICAL CARE

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	15,330	.....	15,330
1983	16,380	.....	16,380
1984	17,895	.....	17,895
1985	20,300	.....	20,300
1986	23,285	.....	23,285
1987	26,705	.....	26,705

Authorization

Section 106.

Description

Employees do not pay tax on their employer's contributions to accident and health plans that provide compensation for sickness and injury.

Impact

The exclusion from tax of employer contributions to employee health insurance plans benefits all taxpayers who participate in employer-subsidized plans. A recent survey indicates that about three-fourths of all persons with private health coverage in the U.S. participate in such plans. The exemption allows employers to provide their employees with health insurance coverage at less cost than if employees were paid additional taxable wages in amounts sufficient to purchase the same amount of insurance. Employees are encouraged to seek additional health insurance coverage, since its net after-tax cost is less to them than alternative purchases that must be made with taxable income. This expanded health insurance coverage has led, many believe, to excessive use of health care services, which in turn has helped to drive up health care costs.

While the exclusion benefits a relatively wide range of the population, it provides proportionally greater benefits to persons with

higher incomes, both because they tend to have larger employer-paid health insurance premiums that are excluded from taxation and because they are in higher marginal tax brackets.

Rationale

Originally, employer contributions to employee pension plans were not subject to tax, because noncash fringe benefits were generally considered not to be taxable income. In 1943, an Internal Revenue Service (IRS) ruling made this exemption explicit for employer contributions to group health insurance policies. Employer contributions to individual health insurance policies, however, were declared to be taxable income in an IRS revenue ruling in 1953. Section 106, which was introduced in 1954, was enacted to reverse the 1953 ruling. As a result, all employer contributions to employee health and accident plans are now excluded from taxable income.

The legislative history of section 106 indicates that its purpose was principally to make uniform the tax treatment of employer contributions to group and individual health insurance plans. It also has the effect, as indicated above, of encouraging the expansion of health insurance coverage, although that was not originally its major purpose.

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DEDUCTIBILITY OF MEDICAL EXPENSES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	3,925		3,925
1983	4,175		4,175
1984	4,190		4,190
1985	4,495		4,495
1986	4,840		4,840
1987	5,305		5,305

Authorization

Section 213.

Description

Medical expenses paid by an individual, including medical insurance premiums, may be itemized and deducted from income to the extent they exceed 3 percent of adjusted gross income (AGI). In computing medical expenses, amounts paid for medicine and drugs may be taken into account only to the extent they exceed 1 percent of AGI. In addition, the 3-percent floor notwithstanding, an amount—not in excess of $150 per year—equal to one-half of medical insurance premiums for the year may be deducted.

Impact

For the 40 percent of taxpayers who itemize their deductions, the medical expense deduction serves to ease the financial burden of extraordinary and involuntary expenses. The deduction is not limited to involuntary expenses, however; it also covers the cost of cosmetic surgery, rest cures, and other optional expenses. In fact, with the substantial expansion of health insurance coverage in recent years, a significant share of the out-of-pocket medical expenses now deducted is for procedures that are not generally reimbursed by insurance because they are considered discretionary. Like the exclusion for employer-paid health insurance premiums, the medical expense deduction encourages the use of medical services, thereby helping to bid up their price. And like all deductions, the medical expense deduction produces higher tax savings per dollar of deduction for taxpayers in higher income tax brackets.

Rationale

Health costs in excess of a given floor were first allowed as a deduction in 1942 in order to maintain high standards of public health and to ease the burden of high wartime tax rates. Originally, the deduction was allowed only to the extent that medical expenses exceeded 5 percent of AGI—considered to be the average family medical expense level—and was subject to a $2,500 maximum. In 1951, the floor was removed for taxpayers 65 or over. In 1954, when the Internal Revenue Code was substantially revised, the percentage of AGI floor was reduced to 3 percent and the 1-percent floor was imposed on drugs and medicines. The dollar ceiling was increased several times until it was finally eliminated in 1965. In that year, the aged were made subject to the floor and the partial deduction for health insurance premiums was allowed without a floor. Since insurance premiums help to even out health expenditures and make it less likely that such expenses can be deducted, it was reasoned that half the cost of insurance premiums should be outside the floor to prevent the tax system from discouraging the purchase of health insurance.

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EXCLUSION OF INTEREST ON STATE AND LOCAL HOSPITAL BONDS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	210	430	640
1983	250	505	755
1984	290	590	880
1985	330	665	995
1986	365	735	1,100
1987	395	805	1,200

Authorization

Sections 103 (a) and (b) and Revenue Ruling 63-20.

Description

The interest on bonds issued by State and local governments to finance construction of both public and private hospitals may be excluded from gross income regardless of issue size. The bonds issued for construction of privately owned hospitals are backed by the revenues received from the facilities built with the bond proceeds. Interest on the bonds is tax exempt because in form, but not in substance, the bonds are a debt of a State or local government.

Impact

Tax-exempt hospital bonds subsidize the cost of hospital construction. Because the interest is tax exempt, the issuer can offer bonds at lower interest rates than a private hospital would pay if it issued taxable bonds. Reported hospital bond sales increased from $3.6 billion in 1980 to $5.1 billion in 1981, accounting for approximately 9 percent of all new long-term tax-exempt financing in that year. Tax-exempt bonds finance about half of all new hospital construction, and approximately three-fourths of all bonds issued are for privately owned facilities. The use of tax-exempt bonds to finance medical equipment has been growing especially rapidly in recent years.

Rationale

The use of tax-exempt bonds for hospital construction has generally been permitted on the grounds that they serve a public pur-

pose. Before 1968, any hospital construction could be financed with tax-exempt bonds because the tax code did not prohibit the use of industrial development bonds for nonexempt, for-profit institutions. Since 1968, when restrictions were placed on the use of IDB's, proprietary medical institutions have been subjected to the rules governing small issue IDB's. (For further details, see the section in function 370 on the Exclusion of Interest on State and Local Industrial Development Bonds.) Tax-exempt not-for-profit hospitals may issue bonds themselves if they meet the requirements of revenue ruling 63–20, or local agencies may issue tax-exempt bonds for them under sections 103(a) or 103(b) of the tax code. Tax-exempt bonds may be issued for construction, remodeling and capital equipment.

Further Comment

The necessity of providing subsidies for new hospital construction has come into question because of the current national surplus of hospital beds. Excess hospital capacity has resulted in sharp cutbacks in direct federal subsidies for hospital construction. The main argument against repealing the tax exemption for private hospital bonds is that some areas still lack adequate hospital facilities, even though nationally the supply of hospital beds is more than sufficient. A possible solution may be to permit the use of hospital bonds in areas that have a shortage of adequate facilities. Another, and possibly preferable solution would be to provide direct subsidies to areas with shortages. Direct subsidies may be a less expensive and more efficient alternative, since the entire subsidy would go to the institution; with tax-exempt bond financing, between a fourth and a third of the subsidy goes to bondholders, underwriters and bond counsel. Direct subsidies would also help to relieve the pressures on the municipal bond market, where rates have been rising more rapidly than rates on taxable issues, so that the savings usually realized from tax exemption are declining.

In February 1982, the Reagan administration proposed restrictions in the use of tax-exempt bonds for private purposes, which would limit the use of tax-exempt bonds for private hospitals. (For a more detailed discussion of these restrictions. (See the section in function 370 on the Exclusion of Interest on State and Local Industrial Development Bonds.)

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EXCLUSION OF SOCIAL SECURITY BENEFITS

Disability Insurance Benefits, OASI Benefits for Retired Workers, and Benefits for Dependents and Survivors

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals			Corporations			Total		
	DI benefits	OASI benefits for retired workers	Benefits for dependents and survivors	DI benefits	OASI benefits for retired workers	Benefits for dependents and survivors	DI benefits	OASI benefits for retired workers	Benefits for dependents and survivors
1982..	915	9,980	1,915	.....	.....	.....	915	9,980	1,915
1983..	910	10,525	1,970	.....	.....	.....	910	10,525	1,970
1984..	910	10,955	2,040	.....	.....	.....	910	10,955	2,040
1985..	950	11,825	2,200	.....	.....	.....	950	11,825	2,200
1986..	1,000	12,790	2,385	.....	.....	.....	1,000	12,790	2,385
1987..	1,060	13,765	2,565	.....	.....	.....	1,060	13,765	2,565

Authorization

I.T. 3194, 1938–1 C.B. 114 and I.T. 3229, 1938–2136, as superseded by Rev. Rul. 69–43, 1969–1 C.B. 310; I.T. 3447, 1941–1 C.B. 191, as superseded by Rev. Rul. 70–217, 1970–1 C.B. 12.

Description

Social security benefits to persons who are aged or disabled, and to dependents and survivors of persons receiving retirement benefits, are not included in adjusted gross income. In this respect, the tax treatment differs from that of other pension benefits, which are fully taxable after the annuitant has recovered his or her own contributions.

Impact

The elderly benefit most from this treatment, since most social security payments are made to the elderly (see table above). Because the exclusion of benefits is worth more to taxpayers the greater their marginal tax rate, recipients with substantial amounts of taxable income benefit more than do most others.

ESTIMATED DISTRIBUTION OF RECIPIENTS, SOCIAL SECURITY BENEFITS, AND TAX SAVINGS BY EXPANDED INCOME CLASS

Expanded income class (in thousands of dollars)	Percent of all returns with social security benefits by income class	Percent of social security benefits received by income class	Percent of tax savings from exclusion by income class
Below 5	70.1	68.0	28.5
5–10	15.8	17.3	30.3
10–15	6.5	6.6	14.9
15–20	3.5	3.4	8.9
20–30	2.6	2.7	8.2
30–50	1.1	1.4	5.6
Above 50	.5	.7	3.5
Total	100.0	100.0	100.0

Rationale

The exemption for social security payments has never been established by statute; it derives from administrative ruling I.T. 3447, issued in 1941. A Supreme Court decision in 1937 and a 1938 IRS ruling regarding lump sum payments may have been influential in resolving the issue. In 1937, the Supreme Court characterized social security as "general welfare" (*Helvering* v. *Davis,* 301 U.S. 619, 640). Two 1939 rulings made lump sum distributions nontaxable (I.T. 3194 and I.T. 3229); internal memoranda suggested that the payments were considered in the nature of a gift. The reasons underlying the 1941 IRS ruling on monthly payments appear to include: (1) the benefits are gratuities and thus not subject to income tax because gifts are not taxable; (2) the Congress indicated its intent that the benefits not be taxable since it did not specifically make them taxable; and (3) the benefits are in the nature of public assistance for the general welfare and the Congress did not intend to tax with one hand what it pays out with the other.

Further Comment

If Social Security payments received the same tax treatment as private pension benefits, about 83 percent of benefits on average would be included in taxable income, although this figure could vary considerably depending on an individual's circumstances. The 1979 Advisory Council on Social Security recommended that half of benefits should be taxed. Taxing half of benefits would bring the tax treatment of social security closer to that of private sector pensions, and would probably also be administratively simpler for the Social Security Administration and the IRS than trying to apply the precise private pension rules.

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EXCLUSION OF RAILROAD RETIREMENT SYSTEM BENEFITS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	380	.....	380
1983	370	.....	370
1984	385	.....	385
1985	400	.....	400
1986	415	.....	415
1987	435	.....	435

Authorization

45 U.S.C. 228, Railroad Retirement Act of 1935, as amended.

Description

At present, railroad retirement is basically patterned after the two-part retirement income plans available to other employees in the private sector—an annuity component, which substitutes for social security benefits and currently accounts for about 60 percent of total benefits, and a corporate-type component, which resembles private sector pension benefits and currently accounts for about 30 percent of the total. (About 10 percent is accounted for by other minor benefits.)

Impact

The exclusion benefits only retired members of the railroad retirement system and their dependents. Because the retirement benefits are composed of elements of both social security and private pensions, tax-free payments to recipients are generally larger than those under social security. In fact, benefits typically paid newly retired members significantly exceed after-tax income earned just before retirement.

Rationale

While this exclusion has a statutory foundation, the reasons supporting it have not been stated. Presumably they are similar to those stated for social security.

Further Comment

Railroad retirement benefits replace a larger portion of wages, after tax, than do nearly all other benefits paid to blue collar workers. (At present, benefits for new retirees with spouses may often exceed $20,000.) Many proposals designed to aline railroad retirement more closely with other private sector retirement practices have called for taxing the non-social-security component of the program, which as noted above, represents about 40 percent of railroad retirement benefits.

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EXCLUSION OF WORKMEN'S COMPENSATION BENEFITS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	3,100		3,100
1983	3,495		3,495
1984	3,965		3,965
1985	4,665		4,665
1986	5,550		5,550
1987	6,635		6,635

Authorization

Section 104(a)(1).

Description

Workers' compensation benefits are not taxable.

Impact

The provision reduces tax burdens during periods of illness. It also exempts benefits for permanent injuries. The benefit amounts are specified by State law (in contrast to the sick pay exclusion, where payments are subject to the employer's discretion).

Rationale

A rationale for this provision is not offered in the committee reports accompanying its enactment in 1918.

Further Comment

The level of workers' compensation is specified by law and is related to salary level. Minimum and maximum benefits levels apply. Payments are based on degree of disability and may be related to family size, but not to the amount of other family income, including any earnings of the beneficiary. If the benefits were made taxable, their level and structure might require adjustment.

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EXCLUSION OF SPECIAL BENEFITS FOR DISABLED COAL MINERS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	95		95
1983	90		90
1984	85		85
1985	85		85
1986	85		85
1987	90		90

Authorization

30 U.S.C. 801 and Revenue Ruling 72-400, 1972-2 C.B. 75 (under sec. 104(a)(1) of the Internal Revenue Code).

Description

Payments made to coal miners or their survivors for death or disability resulting from pneumoconiosis (black lung disease) under the Federal Coal Mine Health and Safety Act of 1969 (as amended by the Black Lung Benefits Act of 1972, the Black Lung Benefits Reform Act of 1977 and the Black Lung Benefits Revenue Act of 1981) are exempt from income tax.

There are two types of black lung programs. The first involves Federal payments to coal miners and their survivors due to death or disability, payable for claims filed before July 1, 1973 (Dec. 31, 1973, in the case of survivors). Monthly cash benefits are related to the GS-2 civil service pay scale and number of dependents. The benefits scale rises from payments of $293.20 for a disabled miner without dependents to $586.40 for a miner with three or more dependents. In addition, a miner (but not a dependent or survivor) is eligible for medical and rehabilitation benefits for black lung disease and directly associated illnesses. This program currently provides total annual payments of around $1 billion to approximately 400,000 beneficiaries.

The second program requires coal mine operators to insure payment of black lung benefits in a federally mandated workers' compensation program. Benefits include medical treatment as well as cash payments which, in general, are the same as provided under

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the program described above. These benefits are paid from a trust fund financed by a tax on coal production if there is no responsible operator (an operator for whom the miner worked 1 year) or if the responsible operator is in default. This program provides total annual payments of around $750 million to approximately 200,000 claimants.

Impact

Black lung benefits are generally too low by themselves to subject the recipients to income tax liabilities. Therefore, those who benefit from the exclusion are likely to be recipients with other employment or with working spouses. In fact, one criticism of the black lung benefit program is that disability benefits continue for recipients who work in some other occupation.

Rationale

Payments made as a result of claims filed before December 31, 1972, were specifically excluded from Federal income tax by the Black Lung Benefits Act of 1972. Later payments are excluded by revenue ruling because they are considered to be in the nature of workers' compensation.

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EXCLUSION OF UNTAXED UNEMPLOYMENT INSURANCE BENEFITS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	2,060		2,060
1983	2,710		2,710
1984	2,410		2,410
1985	2,185		2,185
1986	2,200		2,200
1987	2,250		2,250

Estimated Revenues Loss

Fiscal Year (Revenues to be furnished by JCT).

Authorization

I.T. 3230, 1938-2 C.B. 136, Rev. Rul. 55-652, 1955-C.B. 21, Rev. Rul. 70-280, 1970-1 C.B. 13, Rev. Rul. 73-154, 1973-1 C.B. 40, Rev. Rul. 76-63, 1976-1 C.B. 14, Rev. Rul. 76,144, Rev. Rul. 76-229, 1976-1 C.B. 19 and Section 85.

Description

Prior to 1979, Government-paid unemployment compensation benefits, while not expressly excluded from taxable income, were exempt from taxation under a series of Internal Revenue Service rulings. The Revenue Act of 1978 (Public Law 95-600) included a provision requiring that half of the sum of a single taxpayer's adjusted gross income and his unemployment benefits in excess of $20,000 ($25,000 for joint returns) be included in adjusted gross income. This change, first effective in 1979, brought the tax treatment of government-paid benefits more into line with that of private unemployment compensation, which is fully taxable to the extent that it exceeds prior contributions.

Impact

Tax benefits from the partial exclusion of unemployment compensation depend on the size of payments and on the taxpayer's marginal tax bracket. While the partial exclusion is of little value

to recipients with no other sources of income or to high-income taxpayers for whom benefits are fully taxable, it can be of substantial value to middle-income taxpayers with some investment income, an employed spouse, or earnings during part of the year.

ESTIMATED DISTRIBUTION OF RETURNS OF RECIPIENTS, UNEMPLOYMENT COMPENSATION PAYMENTS, AND TAX SAVINGS BY EXPANDED INCOME CLASS

Expanded income class (dollars in thousands)	Percent of all returns with unemployment compensation by income class	Percent of untaxed unemployment benefits received by income class	Percent of tax savings from remaining exclusion by income class
Below 5	38.6	37.3	17.2
5–10	24.2	26.1	29.3
10–15	15.6	18.3	23.9
15–20	11.4	12.4	19.2
20–30	8.3	5.9	10.5
30–50	1.6	(1)	(1)
Above 50	.3	(1)	(1)
Total	100.0	100.0	100.0

[1] Less than 0.05 percent.

Rationale

The exemption of any portion of government-paid unemployment compensation has never been established by statute; it derives from a series of administrative rulings beginning in the 1930's. These rulings probably reflected the longstanding policy of the Internal Revenue Service to exempt from taxation legislatively provided social welfare benefits.

Further Comment

Recent studies have suggested that as much as half of all unemployment can be traced to job losses involving only temporary layoffs where employers rehire former workers whose layoffs have been cushioned by unemployment benefits. Benefit payments to low- and middle-income workers while on layoff frequently approach after-tax income levels from working, making it easier for these workers to wait to be rehired rather than look for another job. Taxing all benefits, it is argued, would lessen this advantage and provide an incentive for unemployment recipients to seek immediate employment.

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EXCLUSION OF PUBLIC ASSISTANCE BENEFITS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	445		445
1983	430		430
1984	430		430
1985	440		440
1986	455		455
1987	470		470

Authorization

No general statutory authorization. A number of revenue rulings under section 61 have declared specific types of public assistance payments excludable.

Description

The Government provides public assistance benefits tax free to individuals either in the form of cash payments or by providing certain goods and services free of charge. Cash payments come mainly from the Aid to Families with Dependent Children (AFDC) and Supplemental Security Income (SSI) programs. (Traditionally, the tax benefits from inkind payments—primarily, food stamps, medicaid, and housing assistance—have not been included as part of the tax expenditure budget because of the difficulty in determining their value to individual recipients.)

Impact

Because of the relatively low level of public assistance, cash payments and other income of recipients, most beneficiaries would have no income tax liability even if cash payments were made taxable. Recipients who benefit at all tend to be those receiving high cash payments or those employed part of the year and receiving assistance during the remainder.

ESTIMATED DISTRIBUTION OF RETURNS OF RECIPIENTS, PUBLIC ASSISTANCE CASH BENEFITS, AND TAX SAVINGS BY EXPANDED INCOME CLASS

Expanded income class (in thousands of dollars)	Percent of all returns with public assistance cash benefits by income class	Percent of public assistance benefits received by income class	Percent of tax savings from exclusion by income class
Below 5	84.9	89.6	44.3
5–10	12.1	8.5	44.3
10–15	2.6	1.6	9.5
15–20	.4	.2	1.5
20–30	.1	(1)	.3
30–50	(1)	(1)	.1
Above 50	(1)	(1)	(1)
Total	100.0	100.0	100.0

[1] Less than 0.05 percent

Rationale

Revenue rulings generally exclude government transfer payments from income because they are considered to be general welfare payments. While no specific rationale has been advanced for this exclusion, the reasoning may be similar to that for social security payments—that they are in the nature of gifts, and that the Congress did not intend to tax with one hand what it pays out with the other.

Further Comment

Among the issues involved in the tax treatment of public assistance are whether such cash payments should be treated as taxable income, and, if so, whether similar treatment should be extended to inkind benefit payments. If present levels of exemptions and the zero bracket amount are deemed to reflect a general agreement on an income level below which taxes are not to be paid, then cash payments should be treated as taxable income, just as other income sources are. Valueing Government transfers of goods and services may present some difficulty, although this would be less true for food stamps that are easily transferred among individuals than for a program like medicaid. Nonetheless, a system which taxes some types of income but not others introduces inequities among individuals with similar resources.

Tax-free benefits generally also reduce the incentives among recipients to seek employment, although the level of work response to most changes in income-tested programs appears to be slight.

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EXCLUSION OF DISABILITY PAY

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	155		155
1983	145		145
1984	135		135
1985	130		130
1986	130		130
1987	130		130

Authorization

Section 105(d).

Description

Individuals under age 65 who have retired on disability and are permanently and totally disabled are entitled to a maximum exclusion from income of $100 a week ($5,200 a year) of qualified payments received because of the disability. These payments must be received by employees (but not self-employed individuals) under accident and health plans financed wholly or partially by employers. The excludable amount must be reduced on a dollar-for-dollar basis by the amount by which the taxpayer's (or the couple's, in the case of a joint return) adjusted gross income (including disability income) exceeds $15,000.

Impact

The exclusion of disability payments is designed to reduce the tax burden of individuals under age 65 who receive such payments and are unable to continue working. The adjusted gross income phaseout focuses relief on low- and middle-income taxpayers. At age 65, taxpayers become ineligible for the disability pay exclusion, but are eligible for the tax credit for the elderly (and may also receive tax-free social security benefits).

Rationale

From 1954 to 1976, certain amounts received under wage continuation plans when an employee was absent from work on ac-

count of personal injury or sickness were excluded from income. The purpose was to equalize the treatment of employer-financed sick pay plans with the treatment of plans administered by insurance companies. In 1976, the prior law was substantially revised because of: (1) The inequity in the tax treatment of sick employees compared to working ones (sick pay in lieu of wages was exempt from tax while the same payments if made as wages were taxed); (2) the inequity in the distribution of the benefits (low- and middle-income taxpayers received lower tax benefits than higher income taxpayers on the same amounts of excludable sick pay because of the progressive rate structure); and (3) the complexity (there was a variable waiting period for the exclusion to take effect, based on a complicated formula that related disability pay to prior wages).

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NET EXCLUSION OF PENSION CONTRIBUTIONS AND EARNINGS

Employer Plans

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	25,765	.....	27,765
1983	27,500	.....	27,500
1984	30,545	.....	30,545
1985	35,630	.....	35,630
1986	42,060	.....	42,060
1987	48,540	.....	48,540

Authorization

Sections 401–407, 410–415.

Description

Employer contributions to qualified pension, profit-sharing, stock bonus, bond purchase, and annuity plans on behalf of an employee are not taxable to the employee at the time they are made. The employer generally receives a current deduction for these contributions. The earnings on the plan's assets are not taxed until distributed. The employee is taxed at the time he begins to receive benefits under the plan (with appropriate adjustments where he has contributed). A pension or profit-sharing plan is a qualified plan only if it is established by an employer for the exclusive benefit of employees and their beneficiaries. In addition, the plan must satisfy certain requirements, including nondiscrimination, vesting, and funding.

Impact

The tax benefit is composed of two elements: (1) the average employee's marginal tax rate will be lower during his retirement years than during his working life because of lower income and special tax provisions for the aged; and (2) current aggregate pension contributions and investment income which are not taxed exceed aggregate amounts paid out as taxable benefits.

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Once an employee's rights to a pension become nonforfeitable, he enjoys a tax deferral. There are conflicting views concerning whether employers also enjoy tax deferral. Their deductions may be viewed as accelerated from the time the employee's rights become nonforfeitable to the time at which the contributions are made. Under this view, the employer's liability is to pay pensions when due, and making the contribution amounts to a shifting of the form of the employer's assets. On the other hand, it is argued that the employer's deduction is not accelerated because the contribution discharges a current expense, the pension cost for the current period.

The employees who benefit from this provision are primarily middle and upper income taxpayers whose employment has been sufficiently continuous for them to qualify for benefits in a company or union-administered plan. Lower income employees also benefit proportionately less from this tax expenditure because a significant number of employer plans are integrated with the social security system. Under these plans, social security contributions and benefits are counted in determining whether the plans discriminate in favor of officers, shareholders, or highly paid persons. Thus, for example, an employer may limit plan contributions to a percentage of earnings in excess of the taxable wage base ($32,400 in 1982) or may reduce plan benefits by a percentage (not to exceed 87½ percent) of social security benefits.

Rationale

This basic treatment was adopted initially in 1921 and significantly expanded in 1942 and 1974 to provide substantial tax incentives for the establishment of nondiscriminatory retirement plans.

Further Comment

Several questions continue to be raised apart from the basic issue of a tax exclusion for saved income: Should the dollar limitation on self-employed plans differ from that allowed to corporate plans? Should the maximum benefit permitted under qualified plans remain indexed to the cost of living? [The maximum dollar limitation applicable to defined benefit plans in 1982 is $136,425 ($75,000 indexed for inflation since 1974), and the maximum limitation applicable to defined contribution plans in 1982 is $45,475 ($25,000 indexed for inflation since 1974).] Should employees be permitted to diminish their retirement savings by taking loans against the plan benefits or pledging such amounts as security for a loan? Should the rules governing integration with social security be tightened so that relatively increased contributions and benefits would be provided for lower income employees?

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NET EXCLUSION OF PENSION CONTRIBUTIONS AND EARNINGS

Plans for Self-Employed

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individual	Corporations	Total
1982	1,005	.....	1,005
1983	1,065	.....	1,065
1984	1,050	.....	1,050
1985	1,075	.....	1,075
1986	1,145	.....	1,145
1987	1,215	.....	1,215

Authorization

Sections 219–220, 401–405, 408–415.

Description

A person or profit-sharing plan is a qualified plan only if it is established by an employer for the exclusive benefit of employees or their beneficiaries. For this purpose, a sole proprietor is considered both an employee and the employer, and a partnership is considered the employer of each partner.

A qualified plan which benefits a self-employed individual (a sole proprietor or partner) is referred to as an "H.R. 10 plan" or "Keogh plan" and is subject to special rules which are, in addition to the other qualification requirements under the Code. These special rules include limits on the contributions and benefits which can be provided for a self-employed individual. These limits are generally lower than the overall limits on contributions and benefits applicable with respect to all employees under qualified plans.

Under a qualified defined contribution H.R. 10 plan, annual deductible contributions on behalf of a self-employed individual are generally limited to the lesser of $15,000 or 15 percent of net earnings from self-employment. Regardless of the 15-percent limitation, a self-employed individual may deduct a minimum of $750 annually. Under a qualified defined benefit H.R. 10 plan, the annual benefit accruals for a self-employed individual are limited by a special schedule designed to permit the accrual of an annual pension bene-

fit no greater than that which could be provided by the accumulated annual contributions on behalf of a self-employed individual permitted under a defined contribution H.R. 10 plan.

Income and gain on amounts held under a qualified plan are not taxed until distributed. Distributions in excess of employee contributions are included in the participant's income when distributed.

Impact

These provisions, like those for employer plans, allow deferral of tax liability both on the deductible contributions themselves and the earnings of the fund. In addition, when the individual receives payments from the fund, he is likely to be in a lower tax bracket than during his earning years due to the probability of reduced income and the existence of other tax provisions which reduce the tax liability of the elderly and retired.

The tax benefits of self-employed plans are enjoyed more by higher income individuals than are those of employer plans because professional and other higher income self-employed individuals are more likely to be able to set aside the maximum contribution amounts.

The extent to which self-employed plans encourage more saving, rather than changing the form in which the wealth is held, is uncertain. Of particular concern was the widespread use of loans from such plans. Because Congress believed such loans diminished retirement savings, the Economic Recovery Tax Act of 1981 (ERTA) expanded to all partners the rule under which a loan from an H.R. 10 plan, or the use of an interest in the plan as security for a loan, is treated as a distribution.

Rationale

The tax benefits for self-employed individuals are intended to provide treatment similar to that afforded employees securing benefits under employers' qualified plans. This legislation was enacted in 1962. It was considerably liberalized in 1974 and again in 1981 to make these plans more attractive.

Further Comment

Several questions continue to be raised apart from the basic issue of a tax exclusion for saved income: Should the dollar limitation on self-employed plans differ from that of the individual retirement accounts? Should the dollar limitations on these plans be below the maximum amounts allowed corporations?

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NET EXCLUSION OF PENSION CONTRIBUTIONS AND EARNINGS

Individual Retirement Plans

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	1,555		1,555
1983	2,695		2,695
1984	3,255		3,255
1985	3,860		3,860
1986	4,310		4,310
1987	4,855		4,855

Authorization

Sections 219, 408.

Description

An individual generally is entitled to deduct from gross income the amount contributed to an individual retirement account or annuity, or used to purchase retirement bonds (referred to collectively as "IRA's").

The annual deduction limit for IRA contributions is the lesser of $2,000 or 100 percent of compensation. Any individual (including an active plan participant) is eligible for the deduction, so long as the individual has compensation includible in gross income and has not attained age 70½ before the close of the taxable year.

A married taxpayer who is eligible to set up an IRA is permitted to make deductible contributions to an IRA for the benefit of the nonworking spouse. The maximum combined annual contribution for both spouses to the two IRA's is 100 percent of earned income or $2,250, whichever is less, and in no event may a contribution exceeding $2,000 be made to either spouse's account.

An employee who is a participant in a qualified plan, tax-sheltered annuity program, or government plan is also permitted a deduction for qualified voluntary employee contributions made by or on behalf of the employee to the plan. The deduction allowed for contributions to an IRA is reduced by the amount of deductible voluntary employee contributions to a plan. Thus, the deduction al-

lowed for the total of (1) an employee's contributions to an IRA and (2) the employee's qualified voluntary employee contributions to a plan (or plans) for a year, generally is limited to the lesser of $2,000 or 100 percent of compensation for the year.

An employee for whom an employer contributes under a simplified employee pension (SEP) is allowed a deduction for the employee's own contributions to the SEP or to a separate IRA without regard to the deduction allowed to the employee for employer contributions to the SEP (generally limited to the lesser of $15,000 or 15 percent of compensation). Under the SEP rules, the annual deduction limit for employer contributions is applied with respect to contributions by, and compensation from, each separate, unrelated employer.

Income and gain on amounts held under an IRA (or contributed to as qualified voluntary employee contributions) are not taxed until distributed. Except in the case of certain correcting distributions, all distributions from IRA's are includible in gross income. Distributions made before age 59½ (other than those attributable to disability or death) are subject to an additional 10-percent income tax. If an individual borrows from an IRA or uses amounts in an IRA as security for a loan, the transaction is treated as a distribution and the usual tax rules for distributions apply.

Impact

These provisions, as those for employer plans, allow deferral of tax liability both on the deductible contributions themselves and the earnings of the fund. In addition, when the individual receives payments from the fund, he is likely to be in a lower tax bracket than during his earning years due to the probability of reduced income and the existence of other tax provisions which reduce the tax liability of the elderly and retired.

The income levels of taxpayers benefitting from IRA's are comparable to those of taxpayers benefitting from employer plans. The primary beneficiaries are those in the middle and upper income classes.

The extent to which IRA's encourage more saving, rather than changing the form in which the wealth is held, is uncertain.

Rationale

The provision for individual retirement accounts (IRA's) was enacted in 1974. The purpose of IRA's was to eliminate the discrimination against employees not covered by pension plans. In 1976, the benefits of an IRA program were extended to a limited degree to the nonworking spouse of an eligible employee. It was thought to be unfair that the nonworking spouse of an employee eligible for an IRA did not have access to a tax-deferred retirement program. In 1978, IRA's were further expanded to permit an employer to contribute an amount not to exceed $7,500 or 15 percent of compensation to a simplified employee plan (SEP) on behalf of a nondiscriminatory group of employees. In the Economic Recovery Tax Act of 1981 (ERTA), the deduction limits for all IRA's were increased to the lesser of $2,000 or 100 percent of compensation ($2,250 for spousal IRA's), and the deduction for employer contribu-

tions to a SEP was increased to the lesser of $15,000 or 15 percent of compensation. In addition, ERTA provided that any individual may maintain an IRA (including an active plan participant) and permitted an IRA deduction for certain qualified voluntary employee contributions to qualified plans.

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EXCLUSION OF OTHER EMPLOYEE BENEFITS

Premiums on Group Term Life Insurance

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	1,900		1,900
1983	1,895		1,895
1984	1,965		1,965
1985	2,110		2,110
1986	2,290		2,290
1987	2,480		2,480

Authorization

Section 79 and L.O. 1014, 2 C.B. 8 (1920).

Description

Employer payments of employee group term life insurance premiums for coverage up to $50,000 are not included in the gross income of the employee.

Impact

These insurance plans, in effect, provide additional income to employees. Because the value of the insurance coverage is not taxable, this income can be provided at less cost to the employer than the gross amount of taxable wages which would have to be paid to an employee to purchase an equal amount of insurance. Group term life insurance is a significant portion of total life insurance covering over 115 million policies and accounting for over 44 percent of all life insurance in force. However, since neither the value of the insurance coverage nor the life insurance proceeds are included in gross income, the value of this fringe benefit is never subject to income tax.

Individuals who are self-employed or who work for an employer without such a plan do not have the advantage of this tax subsidy for life insurance protection.

Rationale

This exclusion was originally allowed, without limitation as to coverage, by administrative legal opinion (L.O. 1014, 2 C.B. 8 (1920)). The reason for the ruling is unclear, but it may have related to supposed difficulties in valuing the insurance to individual employees since the value is closely related to age and other mortality factors. Studies later indicated valuation was not a problem. The limit on the amount subject to exclusion was enacted in 1964. Reports accompanying that legislation reasoned that the exclusion would encourage the purchase of group life insurance and assist in keeping the family unit intact upon death of the breadwinner.

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EXCLUSION OF OTHER EMPLOYEE BENEFITS

Premiums on Accident and Disability Insurance

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	100		100
1983	100		100
1984	100		100
1985	100		100
1986	105		105
1987	110		110

Authorization

Section 106.

Description

Premiums paid by employers for employee accident and disability insurance plans are not included in the gross income of employees.

Impact

As with term life insurance, since the value of this insurance coverage is not taxable, the employer's cost is less than he would have to pay in wages that are taxable, to confer the same benefit on the employee. Employers thus are encouraged to buy such insurance for employees. Because some proceeds from accident and disability insurance plans, as well as the premiums paid by the employer, are not included in gross income, the value of the fringe benefit is never subject to income tax.

Rationale

This provision was enacted in 1954. Previously, only payments for plans contracted with insurance companies could be excluded from gross income. The committee report indicated this provision equalized the treatment of employer contributions regardless of the form of the plan.

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ADDITIONAL EXEMPTION FOR THE BLIND

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	30	.....	30
1983	30	.....	30
1984	30	.....	30
1985	30	.....	30
1986	30	.....	30
1987	30	.....	30

Authorization

Section 151(d).

Description

Blind taxpayers receive a special exemption of $1,000 in addition to the normal personal exemption. The extra exemption is not available for blind dependents.

Impact

The benefits accrue to taxpayers who are blind or have a blind spouse. Because of their disability, blind persons may incur extra expenses to live at a given standard, and the extra exemption helps compensate for this. The amount of tax relief per exemption increases from $120 to $500 as the marginal tax rate increases from 12 percent to 50 percent.

Rationale

Special tax treatment for the blind first appeared in 1943 when additional benefits were available through an itemized deduction. The law was amended in 1948 to offer relief as an exemption so that all blind taxpayers could claim the allowance.

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ADDITIONAL EXEMPTION FOR THE ELDERLY

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	2,355		2,355
1983	2,370		2,370
1984	2,375		2,375
1985	2,455		2,455
1986	2,560		2,560
1987	2,730		2,730

Authorization

Section 151(c).

Description

An additional personal exemption of $1,000 is allowed for a taxpayer who is 65 or older.

Impact

The amount of tax relief per exemption increases from $120 to $500 as the marginal tax rate increases from 12 to 50 percent. This provision offers no assistance to elderly persons who have no tax liability or are claimed as dependents on another taxpayer's return.

Rationale

The additional personal exemption originally was provided in the Revenue Act of 1948 to provide tax relief for the elderly whose income sources were reduced by old age.

Further Comment

The present additional exemption should be viewed within the context of the total transfer payment program currently in force, parts of which provide cash payments that are limited to needy elderly persons.

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TAX CREDIT FOR THE ELDERLY

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	135		135
1983	135		135
1984	135		135
1985	135		135
1986	135		135
1987	135		135

Authorization

Section 37.

Description

Individuals who are 65 or more years old are allowed a tax credit nominally equal to 15 percent of up to $2,500 of taxable income for a single person or on a joint return where only one spouse is 65 or more, or up to $3,750 of taxable income on a joint return where both spouses are 65 or more. The limits of $2,500 and $3,750 are reduced (1) by tax exempt retirement income such as social security benefits, and (2) by one-half of the taxpayer's adjusted gross income over $7,500 for single individuals and over $10,000 for a married couple filing a joint return.

A 15-percent credit is also applicable to the retirement income of individuals under 65 years of age receiving pensions under a public retirement system, and can be elected by married couples where one spouse is under 65. However, qualifying retirement income under this computation is reduced by an earned income phaseout. Thus, if an individual is under 62, the maximum base must be reduced by earned income in excess of $900. If an individual is 62 or over but under 72, the maximum base must be reduced by 50 percent of earned income in excess of $1,200 and under $1,700, and by all earnings over $1,700. This credit is not subject to the adjusted gross income phaseout, however.

Example

A husband and wife are both 66 and file a joint return. He receives a taxable pension of $5,000, wages of $3,000, and a social se-

curity pension of $1,000. She receives a taxable pension of $2,000, wages of $1,000, and a social security pension of $400. They receive interest income of $200 on savings. The tax credit for the elderly is computed as follows:

Maximum amount upon which credit may be based		$3,750.00
Less:		
Husband's social security pension	$1,000.00	
Wife's social security pension	400.00	
One-half of adjusted gross income in excess of $10,000 (½ of $1,200)	600.00	
Total	2,000.00	
Amount on which tax credit is based		1,750.00
Amount of credit (15 percent of $1,750)		262.50

Impact

The maximum credit per individual is $375 (15 percent of $2,500), and $552.50 in the case of a married couple both 65 or over (15 percent of $3,750). Because the amount of eligible income is reduced by the amount of social security benefits received, the primary beneficiaries of this provision are Federal retirees and those State and local government retirees who do not receive social security benefits.

The adjusted gross income phaseout limits the tax relief largely to low- and middle-income taxpayers. In conjunction with the standard deduction and the additional personal exemption for persons 65 or older, the provision permits low-income elderly persons who work to receive substantial amounts of income before becoming taxable. Since public retirees under age 65 are not subject to the adjusted gross income phaseout, they have an advantage over retirees age 65 and over, if income in both cases is solely from pensions.

Because the provision is a credit, its value to a taxpayer is affected only by the level of benefits and not by the tax bracket of the recipient. Nevertheless, the benefits from the credit are slightly less concentrated in the lower range of the income scale than the tax relief from the exclusion of social security benefits.

Rationale

The tax credit for the elderly enacted in 1976 revised and restructured the retirement income credit. The retirement income credit, originally enacted in 1954, was intended to remove inequities between individuals who receive retirement income that was not tax exempt and recipients of social security, which is tax exempt. At that time, many features of the credit were closely related to the social security benefit system. The retirement income credit was applicable to retirement income only. No revision had been made in the maximum amount eligible for the credit between 1962 and 1976, even though social security benefits had increased substantially during that period.

The revised tax credit for the elderly was enacted in 1976 in order to: (1) update the maximum amount of income eligible for the credit; (2) eliminate the complexity of the retirement income credit

which had resulted from patterning it after the social security law; and (3) eliminate the discrimination among individuals depending on it as their source of income. For example, elderly taxpayers who had to support themselves by earning income because they had no retirement income now could qualify for the credit, but had previously been ineligible.

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DEDUCTIBILITY OF CASUALTY AND THEFT LOSSES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	800		800
1983	850		850
1984	930		930
1985	1,035		1,035
1986	1,155		1,155
1987	1,310		1,310

Authorization

Section 165(c)(3).

Description

To the extent it exceeds $100, the uninsured portion of losses attributable to theft, fire, storm, shipwreck, or other casualty, may be deducted from adjusted gross income.

Impact

This provision grants some financial assistance to those who suffer casualties, have tax liability, and itemize deductions. It shifts part of the loss from the property owner to the general taxpayer, and thus serves as a form of insurance. The same dollar amount of loss has a proportionately greater effect on a low-income family than on a higher income family, yet the insurance feature of the deduction is greater for taxpayers in higher income tax brackets.

Rationale

The deduction for casualty losses was allowed under the original 1913 income tax law without distinction between business-related and non-business-related losses. No rationale was offered then. In 1964, the $100 floor on the deduction was enacted, and the purpose of relieving hardship was articulated in the legislative history.

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EARNED INCOME CREDIT

Estimated Revenue Loss [1]

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	555		555
1983	550		550
1984	500		500
1985	475		475
1986	440		440
1987	400		400

[1] The figures in the table indicate the effect of the earned income credit on receipts. The effect on outlays is: $1,255 million in 1982, $1,180 million in 1983, $920 million in 1984, $850 million in 1985, $780 million in 1986, and $720 million in 1987.

Authorization

Section 43.

Description

The tax credit is available to married couples who are entitled to a dependent exemption for a child and to unmarried individuals who maintain a household for a child. The credit equals 10 percent of the first $5,000 of earnings, and thus may not exceed $500 per family. For each dollar of adjusted gross income (or, if higher, earned income) above $6,000, the maximum credit is reduced by 12.5 cents. Thus, between incomes of $5,000 and $6,000, the maximum credit of $500 is received, and the credit is not available to taxpayers with incomes of $10,000 or above.

The credit is subtracted from tax liability, if any. Unlike other tax credits, any amount of the earned income credit in excess of tax liability is paid in cash to the eligible taxpayer. If desired, the taxpayer may file an eligibility certificate with his employer in order to receive advance payments of the credit with his paycheck.

Impact

The earned income credit may be viewed as a partial offset to social security taxes on low-income workers. The combined employer-employee social security tax rate is 13.4 percent (6.7 percent paid by each party). Assuming the employee bears the burden of the employer's portion in the form of lower wages, the 10-percent credit offsets nearly 75 percent of the tax.

The credit may help to encourage low-income workers to obtain employment and, thus, reduce the demand for welfare and unemployment benefits. Because of the phaseout of eligibility for the credit between $6,000–$10,000 of income, virtually all the benefits of the credit are received by persons in the lowest expanded gross income category, $0–$10,000.

Rationale

The earned income credit was first enacted in the Tax Reduction Act of 1975. Providing relief from social security taxes for low-income workers was one purpose. Another reason cited by the tax writing committees was to provide relief to low-income people for recent increases in food and fuel prices. Some opponents believe relief of this nature would be more efficiently administered as a reduction of social security tax payments made by low-income wage earners.

The credit was continued by the Revenue and Adjustment Act of 1975, extended and broadened by the Tax Reform Act of 1976, extended through 1978 by the Tax Reduction and Simplification Act of 1977 and expanded, simplified and made permanent in the Revenue Act of 1978.

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VETERANS BENEFITS AND SERVICES

(1) Exclusion of Veterans Disability Compensation

(2) Exclusion of Veterans Pensions

(3) Exclusion of GI Bill Benefits

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals			Corporations	Total
	Veterans disability compensation	Veterans pensions	GI bill benefits		
1982	1,360	85	175	.....	1,620
1983	1,380	90	145	.....	1,615
1984	1,325	85	135	.....	1,545
1985	1,320	90	120	.....	1,530
1986	1,325	95	105	.....	1,525
1987	1,330	100	95	.....	1,525

Authorization

38 U.S.C. 3101.

Description

All benefits administered by the Veterans' Administration are exempt from income tax. These include veterans disability compensation, veterans pension payments, and education payments.

Impact

Veterans service-connected disability compensation payments are related not to income levels, but to the degree of impairment resulting from the various injuries.

The pensions paid to qualifying nonservice disabled and aged veterans are based on "countable" income. Reaching age 65 or older is considered a *de facto* disability. The larger a veterans' countable income is, the smaller his pension will be. For veterans coming on the rolls after December 31, 1978, countable income includes earnings of the veteran, spouse, and dependent children, if any. Veter-

ans who came on the rolls on or before that date could elect to continue under prior law, which excluded from countable income the income of a spouse, among other items. Therefore, veterans still covered by the prior law could receive the same pension—based on the same amount of countable income—but have quite different amounts of total income when the excluded items are taken into account.

Veterans education benefits vary with the number of dependents and type of training.

Based upon the foregoing criteria, beneficiaries of all three major veterans programs to varying degrees may have amounts of taxable income in addition to their tax-exempt veterans benefits. Thus, the value of tax exemption of these veterans benefits increases with the marginal tax bracket of the recipients.

Rationale

Since 1917, veterans benefits have been exempt from income tax. The original rationale for the exemption is not clear.

Further Comment

One general issue concerning these benefit programs which has been the subject of discussion is whether net (after-tax) benefit differentials should depend on the tax bracket of the recipient. Increases in the amount of direct payments under the programs are alternatives to the current exemption.

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CREDITS FOR POLITICAL CONTRIBUTIONS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	80		80
1983	80		80
1984	80		80
1985	80		80
1986	80		80
1987	80		80

Authorization

Section 41.

Description

Individual, but not corporate, taxpayers are allowed a tax credit equal to one-half of their political contributions to candidates for Federal, State, or local office and to national political parties. The credit cannot exceed $50 for a single individual or $100 for a married couple.

Impact

The credit allows a taxpayer to reduce the cost of a limited amount of political contributions by 50 percent, that is, for each $2 of contributions—up to a limit of $100 per taxpayer—the Federal Government returns a dollar to the taxpayer through lower tax liability, in effect matching the taxpayer's contribution. Because of the dollar limitations, this provision is obviously not of great significance to large contributors.

Rationale

The credit for political contributions was adopted with one-fourth the current limit as part of the Revenue Act of 1971; the maximum amount was increased in 1974 and 1978. The purpose of the credit was to encourage more widespread financing of political campaigns through small contributions.

Further Comment

Before enactment of the Revenue Act of 1978, taxpayers could elect to deduct political contributions up to a limited of $100 (sec. 218). The deduction item was preferable for taxpayers whose income was above the 50-percent bracket. For example, at the maximum rate of 70 percent (in effect for taxable years beginning before 1982), the taxpayer's net cost of $100 contributions was $30; that is, the Government matched the $30 contribution with a $70 contribution. The deduction, unlike the credit, could only be claimed if the taxpayer itemized deductions.

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EXCLUSION OF INTEREST ON GENERAL PURPOSE STATE AND LOCAL DEBT

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	1,925	3,905	5,830
1983	2,165	4,395	6,560
1984	2,410	4,870	7,280
1985	2,620	5,295	7,915
1986	2,810	5,660	8,470
1987	2,975	5,990	8,965

Authorization

Section 103.

Description

In general, interest on the obligations of State and local governments is excludable from gross income.[1]

Impact

Because the interest is exempt from tax, the interest rate on state and local government obligations is lower than the rate on comparable taxable bonds. In effect, the federal government subsidizes States and localities by paying part of their interest cost. For example, if the market rate on tax-exempt bonds is 7 percent when the taxable rate is 10 percent, there is a 3 percentage point subsidy to state and local governments.

Tax-exempt bonds are viewed by some persons as a particularly attractive form of indirect Federal aid because they operate automatically without Federal regulations.

Commercial banks, fire and casualty insurance companies, and high income individuals are the major buyers of tax-exempt bonds. Tax-exempt institutions, such as pension funds, have no incentive to invest in tax-free bonds since the return is much lower than that of taxable securities. Therefore, the tax-exempt nature of state and

[1] For a description of state and local government pollution control and industrial development bonds, see the sections in functions 300 and 370, respectively. The discussion of general purpose state and local obligations excludes consideration of these special purpose obligations.

local debt, in effect, restricts the potential market for these securities to taxable individuals and organizations.

States and localities have traditionally issued tax-exempt bonds to finance public projects, such as schools, roads, sewers, transportation facilities, and Government buildings. Bonds issued for these purposes are usually general obligations of the State or local government. In recent years, States and localities have also been issuing increasing volumes of tax-exempt revenue bonds to provide low-cost financing for quasi-public and private facilities. Revenue bonds now account for approximately 70 percent of all new long-term tax-exempt issues. The growing use of tax-exempt bonds for privately owned facilities, coupled with recent changes in the tax law, have caused tax-exempt interest rates, which are now at record highs, to rise more rapidly than conventional interest rates. As a result, the savings usually realized from tax exemption are eroding, and municipalities are paying relatively higher costs to finance public projects.

Rationale

This exemption has been in the income tax law since 1913, and apparently was based on the belief that the Federal Government could not constitutionally tax such interest. Today, the exemption is justified on other grounds, principally as a means of assisting State and local governments with a minimum of Federal interference.

Further Comment

One possible alternative or supplement to the exclusion would be to give States and localities the choice of issuing either taxable or tax-exempt bonds, with a Federal subsidy for those issuing taxable bonds to compensate them for the higher interest cost that could be incurred. Proponents of this option argue that it would stabilize and expand the municipal bond market and enhance the cost-effectiveness of the subsidy. Others believe that the proposal could result in the eventual diminution of fiscal autonomy of municipal authorities, and would render the subsidy more visible. Some also fear that a subsidized taxable bond market would destroy the tax-exempt market to which State and local governments already are accustomed.

This option would probably result in substantial increases in absolute long-term net outlays by the Federal Government because the direct subsidy payments would likely exceed the increased income taxes paid by the recipients of the taxable securities.

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DEDUCTIBILITY OF NONBUSINESS STATE AND LOCAL TAXES OTHER THAN ON OWNER-OCCUPIED HOMES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	20,395		20,395
1983	21,530		21,530
1984	23,810		23,810
1985	25,570		25,570
1986	28,060		28,060
1987	31,280		31,280

Authorization

Section 164.

Description

An individual can claim certain State and municipal sales, income, and personal property tax payments as itemized deductions.

Impact

This deduction for State and local tax payments benefits only taxpayers who itemize their deductions. They are concentrated in the middle and higher income brackets, largely among persons who own homes, because these are the taxpayers who generally itemize.

The Federal tax deduction for State and local sales taxes and miscellaneous taxes accentuates the generally regressive nature of these taxes because the amount of tax benefit per dollar of deduction increases with the tax bracket of the taxpayer. State and local income taxes generally are progressive, but the Federal deduction lessens the effect of their progressivity.

Rationale

The allowance of a deduction for taxes has always been a part of the income tax structure including the Civil War income tax. Although the legislative history is not explicit, it suggests that taxes were viewed as reducing net income. Some now regard this treat-

ment as a form of revenue sharing. As with many other deductions, no distinction was made between business and nonbusiness taxes. The deduction for the Federal income tax was eliminated in 1917 and, for Federal excise taxes, in 1943. The deduction for State and local taxes on tobacco and alcoholic beverages was eliminated in 1964, along with automobile and drivers' licenses and other State and local selective excise taxes except gasoline taxes.

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TAX CREDIT FOR CORPORATIONS RECEIVING INCOME FROM DOING BUSINESS IN U.S. POSSESSIONS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982		1,195	1,195
1983		1,285	1,285
1984		1,380	1,380
1985		1,500	1,500
1986		1,625	1,625
1987		1,730	1,730

Authorization

Section 936.

Description

A qualifying domestic corporation may elect not to pay tax on income earned in U.S. possessions except the Virgin Islands. A corporation qualifies if, for the 3-year period preceding the end of the tax year, at least 80 percent of its gross income has been from sources within a possession, and at least 50 percent of its gross income is from the active conduct of a trade or business within a possession. This exemption is accomplished by granting a credit equal to the tax which otherwise would be paid on income earned within a possession. Full deductions are provided for dividends received by parent corporations from subsidiaries that elect the possessions credit.

The credit can apply to corporations conducting business in the Commonwealth of Puerto Rico and all possessions of the United States (mainly Guam, the Canal Zone, and Wake Island) except the Virgin Islands.

Impact

Corporations operating in Puerto Rico account for over 99 percent of the estimated revenue loss from this tax expenditure.

Puerto Rico grants substantial exemptions from income tax to encourage corporations to engage in manufacturing operations in

the Commonwealth. Most "possessions corporations" are subsidiaries of U.S. corporations with U.S. (and sometimes foreign) operations. The combination of the possessions credit and Puerto Rican tax holidays results in little or no income tax being paid to any taxing authority. Puerto Rico has claimed that granting these incentives to U.S. firms is a vital part of the continued growth and development of the Puerto Rican economy, and its incentive acts have been drafted with U.S. laws in mind.

A Treasury Department report published in June 1980, indicates that in 1978, the Federal tax expenditure per Puerto Rican employee averaged $12,667 in all manufacturing industries. This was slightly higher than the average compensation of possessions corporations' employees, which was $10,697. For pharmaceutical companies the tax expenditure represented over $43,000 per employee, while for traditional labor intensive industries the tax expenditure averaged less than $3,000 per employee.

The Treasury also estimates that in 1978, 50 percent of the tax expenditure benefits from the possessions corporation exclusion went to pharmaceutical companies. Other types of businesses making substantial use of the exclusion were electrical and electronic equipment manufacturers.

The Treasury report further indicates that 29 companies received roughly 55 percent of the total benefits derived from the possessions corporation rules in 1978.

Rationale

An exclusion for income earned in possessions was enacted in 1921. Floor debate indicated it was intended to encourage export trade (especially to South America) by improving the competitive position of U.S. companies in foreign markets. The exclusion was converted to a credit by the Tax Reform Act of 1976. One reason for this conversion was that the exclusion discouraged the possessions corporation from paying dividends, but rather encouraged parent firms to liquidate their possessions corporations at the end of tax holidays. The 1976 legislation also eliminated an incentive under the prior law for possessions corporations to invest their earnings outside both Puerto Rico and the United States. The proponents of the credit now justify it as necessary to assist the economic growth of Puerto Rico.

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DEFERRAL OF INTEREST ON SAVINGS BONDS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1982	−80		−80
1983	50		50
1984	160		160
1985	225		225
1986	290		290
1987	355		355

Authorization

Section 454.

Description

The Federal Government currently issues Series EE bonds on a discount basis. (Series E bonds were issued prior to 1980.) These savings bonds are redeemable at amounts which increase at a graduated rate throughout the life of the bond. The difference between the discount purchase price and the redemption amount is treated as taxable interest income. However, at the option of the holder, rather than report the increased value each year, an individual may defer paying taxes on the interest until the bond is redeemed (which may extend past the original maturity date).

In addition, Series E and EE bonds can be exchanged for Series HH bonds which pay out interest semiannually. With a conversion to HH bonds, the tax on the interest accured on the Series E or EE bonds can be deferred until the HH bond is redeemed. The semiannual interest payments from the HH bonds are, however, taxable for the year in which they are received.

The tax-free conversion is not available to corporations or to any individual taxpayer who is on the accrual basis.

Impact

The deferral of interest income resulting from owning savings bonds provides two advantages. First, payment of tax on the interest is deferred, amounting to an interest-free loan. Second, if bonds are purchased for retirement purposes, the taxpayer often is in a lower income bracket when the bonds are redeemed.

There has been virtually no analysis of the impact of this provision. If the provision were removed, an increase in the interest rate might be necessary to sell the same amount of bonds. However, the effect of this provision on the demand for savings bonds may be minimal since other factors may be much more significant. These include habit, convenience of a payroll deduction plan, security, patriotism, and the exemption for such income from State and local income taxes.

Rationale

Prior to 1951, a cash-basis taxpayer generally reported interest on U.S. Treasury original issue discount bonds in the year of redemption or maturity, whichever came first. In 1951, when provision was made to extend Series E bonds past their dates of original maturity, a provision was enacted to allow the taxpayer either to report the interest currently, or at the date of redemption, or upon final maturity. The committee reports indicated that the provision was adopted to facilitate the extension of maturity dates.

In 1959 a provision was added to allow taxpayers to convert Series E bonds to Series H bonds without paying tax on the accrued interest. The purpose was to encourage the holding of U.S. bonds.

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Appendix A

Distribution of Selected Items of Tax Expenditures Under Individual Income Tax, by Expanded Income Class [1]

[Amounts in millions of dollars; returns in thousands]

Expanded income class (thousands)[2]	Age exemption		Blind exemption		Dividend exclusion	
	Returns	Amount	Returns	Amount	Returns	Amount
Below $5	407	40	1	(*)	308	4
$5 to $10	2,292	368	27	4	1,285	19
$10 to $15	1,787	407	10	1	1,343	26
$15 to $20	955	260	48	10	1,236	29
$20 to $30	1,094	360	9	2	2,849	84
$30 to $50	765	374	26	8	3,784	166
$50 to $100	362	225	4	2	2,006	130
$100 to $200	108	76	2	1	457	36
$200 and over	33	23	1	(*)	136	11
Total	7,804	2,133	128	28	13,403	505

	Disability pay exclusion		Medical deduction		Real estate tax deduction	
	Returns	Amount	Returns	Amount	Returns	Amount
Below $5	90	52	308	4	325	81
$5 to $10	81	45	1,069	79	1,522	97
$10 to $15	31	22	1,653	155	1,837	191
$15 to $20	31	22	2,362	304	2,710	374
$20 to $30	18	2	5,281	834	6,823	1,429
$30 to $50	22	8	6,715	1,160	8,870	3,252
$50 to $100			2,221	652	2,849	2,291
$100 to $200			368	189	478	725
$200 and over			91	67	109	302
Total	242	129	20,069	3,444	25,523	8,679

Distribution of Selected Items of Tax Expenditures Under Individual Income Tax, by Expanded Income Class[1]

[Amounts in millions of dollars; returns in thousands]

Expanded income class (thousands)[2]	State and local income tax deduction		State and local sales, personal property, and other tax deductions		Home mortgage interest deduction	
	Returns	Amount	Returns	Amount	Returns	Amount
Below $5	306	8	429	7	378	21
$5 to $10	1,319	59	1,579	48	1,468	189
$10 to $15	1,968	131	2,123	97	1,458	334
$15 to $20	2,834	284	3,232	205	2,272	863
$20 to $30	6,761	1,313	7,497	816	5,759	3,575
$30 to $50	8,731	3,952	9,685	1,927	7,842	8,564
$50 to $100	2,810	3,716	3,202	1,169	2,369	4,697
$100 to $200	453	1,682	587	354	343	1,065
$200 and over	100	1,204	155	170	71	279
Total	25,280	12,348	24,489	4,793	21,960	19,587

	Elderly credit		Child care credit		Earned income credit[3]	
	Returns	Amount	Returns	Amount	Returns	Amount
Below $5					2,207	658
$5 to $10	126	21	172	36	3,690	1,064
$10 to $15	235	51	399	94	79	10
$15 to $20	109	19	566	133	21	4
$20 to $30	53	17	1,140	266	4	1
$30 to $50	53	18	1,495	431		
$50 to $100	8	3	221	77		
$100 to $200	(*)	(*)	17	8		
$200 and over	(*)	(*)	2	1		
Total	585	129	4,013	1,045	6,001	1,736

Distribution of Selected Items of Tax Expenditures Under Individual Income Tax, by Expanded Income Class[1]

	Deductibility of nonmortgage interest in excess of investment income		Charitable contributions deduction		Casualty loss deduction	
	Returns	Amount	Returns	Amount	Returns	Amount
Below $5	6	3	328	5	17	1
$5 to $10	68	7	1,448	31	111	3
$10 to $15	492	82	2,145	129	175	21
$15 to $20	1,308	291	3,078	249	282	40
$20 to $30	3,979	1,297	7,433	985	608	108
$30 to $50	5,829	2,842	9,545	2,550	871	243
$50 to $100	1,360	1,501	3,081	2,109	316	173
$100 to $200	149	509	503	1,126	56	60
$200 and over	20	208	113	1,652	18	43
Total	13,211	6,740	27,674	8,836	2,454	692

	Capital gains deduction	
	Returns	Amount
Below $5	105	179
$5 to $10	496	188
$10 to $15	540	342
$15 to $20	536	337
$20 to $30	1,282	1,165
$30 to $50	1,674	2,539
$50 to $100	869	3,337
$100 to $200	228	2,134
$200 and over	63	2,762
Total	5,793	12,983

[1] Estimated for the tax law enacted as of Dec. 31, 1981, and at 1981 income levels.
[2] Expanded income equals adjusted gross income plus minimum tax preferences (mostly excluded capital gains) less investment interest expense to the extent of investment income.
[3] Includes the refundable portion of the earned income credit.
*Less than $500,000 or 500 returns.

Appendix B

FORMS OF TAX EXPENDITURES

Exclusions, Exemptions, Deductions, Credits, Preferential Rates, and Deferrals

Tax expenditures may take any of the following forms: (1) special exclusions, exemptions, and deductions, which reduce taxable income and, thus, result in a lesser amount of tax; (2) preferential tax rates, which reduce taxes by applying lower rates to part or all of a taxpayer's income; (3) special credits, which are subtracted from taxes as ordinarily computed; and (4) deferrals of tax, which result from delayed recognition of income or from allowing in the current year deductions that are properly attributable to a future year.

Computing Tax Liabilities

A brief explanation of how tax liability is computed will help illustrate the relationship between the form of a tax expenditure and the amount of tax relief it provides.

CORPORATE INCOME TAX

Corporations compute taxable income by determining gross income (net of any exclusions) and subtracting any deductions (essentially costs of doing business).

The corporate income tax is a flat rate tax of 46 percent above $100,000 taxable income. Below $100,000, taxable income is taxed at graduated rates in four income brackets of $25,000 each:

Percentage tax rate	*Taxable income*
15 (16 in 1982)	0–$25,000
18 (19 in 1982)	$25–$50,000
30	$50–$75,000
40	$75–$100,000

The limited graduation provided in this structure was intended to furnish tax relief to smaller corporations.

Any credits are deducted from tax liability calculated in this way. The essentially flat statutory rate of the corporation income

tax means there is very little difference in marginal tax rates to cause variation in the amount of tax relief provided by a given tax expenditure to different corporate taxpayers. However, corporations without current tax liability will benefit from tax expenditures only if they can carry back or carry forward a net operating loss or credit.

INDIVIDUAL INCOME TAX

Individual taxpayers compute gross income which is the total of all income items except exclusions. They then subtract certain deductions (deductions from gross income or "business" deductions) to arrive at adjusted gross income. The taxpayer then has the option of "itemizing" personal deductions or taking the standard deductions. The taxpayer then deducts personal exemptions to arrive at taxable income. A graduated tax rate structure into which the standard deduction is built is applied to this taxable income to yield tax liability, and any credits are subtracted to arrive at the net after-tax liability.

Exclusions, Deductions, and Exemptions

The amount of tax relief per dollar of each exclusion, exemption, and deduction increases with the taxpayer's marginal tax rate. Thus, the exclusion of interest from State and local bonds saves $50 in tax for every $100 of interest for the taxpayer in the 50-percent bracket, whereas for the taxpayer in the 25-percent bracket the saving is only $25. Similarly, the extra exemption for persons over age 65 and any itemized deduction is worth twice as much in tax saving to a taxpayer in the 50-percent bracket as to one in the 25-percent bracket.

In general, the following deductions are itemized, i.e., allowed only if the standard deduction is not taken: medical expenses, specified State and local taxes, interest on nonbusiness debt such as home mortgage payments, casualty losses, certain unreimbursed business expenses of employees, charitable contributions, expenses of investment income, union dues, costs of tax return preparation, uniform costs and political contributions. Whether or not a taxpayer minimizes his tax by itemizing deductions depends on whether the sum of those deductions exceeds the limits on the standard deduction. Higher income individuals are more likely to itemize because they are more likely to have larger amounts of itemized deductions which exceed the standard deduction allowance. Homeowners generally itemize because deductibility of mortgage interest and property taxes generally leads to larger deductions than the standard deduction.

Preferential Rates

The amount of tax reduction that results from a preferential tax rate (such as the reduced rates on the first $100,000 of corporate income) depends on the difference between the preferential rate and the taxpayer's ordinary marginal tax rate. The higher the marginal rate that would otherwise apply, the greater is the tax relief from the preferential rate.

Credits

A tax credit (such as the investment credit) is subtracted directly from the tax liability that would accrue otherwise, thus, the amount of tax reduction is the amount of the credit and is not contingent upon the marginal tax rate. A credit can (with one exception) only be used to reduce tax liabilities to the extent a taxpayer has sufficient tax liability to absorb the credit. Most tax credits can be carried backward and/or forward for fixed periods, so that a credit which cannot be used in the year in which it first applies can be used to offset tax liabilities in other prescribed years.

The earned income credit is the only tax credit which is now refundable. That is, a qualifying individual will obtain in cash the amount of the refundable credit in excess of his tax liability when he files his tax return for the year in which the credit applies.

Deferrals

Deferral can result either from postponing the time when income is recognized for tax purposes or from accelerating the deduction of expenses. In the year in which a taxpayer does either of these, his taxable income is lower than it otherwise would be, and because of the current reduction in his tax base, his current tax liability is reduced. The reduction in his tax base may be included in taxable income at some later date. However, the taxpayer's marginal tax rate in the later year may differ from the current year rate because either the tax structure or the applicable tax rate has changed. Furthermore, in some cases the current reduction in the taxpayer's tax base may never be included in his taxable income. Thus, deferral works to reduce current taxes, but there is no assurance that all or even any of the deferred tax will be repaid. On the other hand, the tax repayment may even exceed the amount deferred.

A deferral of taxes has the effect of an interest-free loan for the taxpayer. Apart from any difference between the amount of "principal" repaid and the amount borrowed (that is, the tax deferred), the value of the interest-free loan—per dollar of tax deferral—depends on the interest rate at which the taxpayer would borrow and on the length of the period of deferral. If the deferred taxes are never paid, the deferral becomes an exemption. This can occur if, in succeeding years, additional temporary reductions in taxable income are allowed. Thus, in effect, the interest-free loan is refinanced; the amount of refinancing depends on the rate at which the taxpayer's income and deductible expenses grow and can continue in perpetuity.[1]

TEMPORARY EXCLUSIONS

The Domestic International Sales Corporation (DISC) provision is an example of deferral through a temporary exclusion of income,

[1] The tax expenditures for deferrals are estimates of the difference between tax receipts under the current law and tax receipts if the provisions for deferral had never been in effect. Thus, the estimated revenue loss is greater than what would be obtained in the first year of transition from one tax law to another. The amounts are long run estimates at the level of economic activity for the year in question.

with recogniztion of the income for tax purposes occurring subsequently. In some cases, the deferral may continue indefinitely and the effect is a permanent exclusion of taxable income.

ACCELERATED DEDUCTIONS

More commonly, deferrals occur through the acceleration in the deduction of expenses. Ordinarily, the cost of acquiring an income-producing asset which undergoes economic decline (such as a machine) is capitalized and deducted over the asset's useful life. The amount of deduction taken in each year depends on the useful life and the rate of depreciation applied. The shorter the useful life and the higher the rates applied, the more quickly deductions are taken. To reflect net income, the share of the asset cost used up in any one year should be deducted as an expense against income produced by the asset in that year. However, if a larger amount is deducted in earlier years, tax liability is lower than it otherwise would be. Just the reverse is true in later years when the deduction is lower and tax liability is higher than it otherwise would be, and thus a tax deferral occurs.

Rapid write-off methods which are considered tax expenditures include: (1) expensing 100 percent of capital costs as incurred, (2) using a shorter life (as in the accelerated capital cost recovery system), (3) using a faster rate (as in accelerated depreciation on buildings), and (4) using various 5-year amortization provisions. The tax saving from various rapid write-off methods is illustrated by the following example.

Assume a $10,000 asset with an even rate of economic depreciation over a 10-year life is held by a taxpayer with a marginal tax rate of 50 percent. The appropriate deduction, in this case "straight-line," would be $1,000 each year, and the resulting annual tax reduction would be $500 (50 percent of $1,000).

Expensing capital acquisitions

If the asset is expensed, the entire amount ($10,000) is deductible in the first year, and the tax reduction is $5,000 (50 percent of $10,000). This tax reduction is $4,500 greater than the $500 amount resulting from the "straight-line" method (where 10 percent is written off in each year of the 10-year life). In the second and all following years, no deduction will be taken. Thus, the net effect of expensing the cost of the asset is a $4,500 loan from the government which is paid back without interest over the next 9 years (as no depreciation is deducted).

Shorter than actual useful lives

The use of any life shorter than the "true" 10-year economic life (in this example) provides similar but smaller amounts of tax benefit. If a 5-year life is used instead of a 10-year life, the deduction allowed in each of the first 5 years is $2,000, and the net tax deferral each year is $500 ($2,000 − $1,000 × 50 percent) which is ultimately repaid in the last 5 years of the asset's actual useful life when no deductions are taken.

Rapid rate depreciation

There are several rapid rate alternatives to the straight-line method. The use of a rapid rate simply allows larger deductions in the earlier years of the asset's useful life (but does not affect the period over which the asset is written off). For example, the declining balance method applies a larger than straight-line rate against the balance (i.e., the asset cost less the previously allowed depreciation) remaining each year. To illustrate with a $10,000 asset, double declining balance depreciation in the first year is $2\times1/10\times\$10,000$ or $2,000—twice the straight-line depreciation, for a net tax saving of $500 (50 percent of $1,000). In the next year, the deduction is $2\times1/10\times\$8,000$ or $1,600, for a net tax saving of $300. Although depreciation deductions will continue over the entire life of the asset, they will be larger at the beginning and smaller at the end of the period.

For certain types of machinery and equipment, the pattern of economic decline may be more closely approximated by a rapid depreciation method than by straight-line. Indeed, the use of an accelerated depreciation rate for machinery and equipment is not considered a tax expenditure; however, it is considered so for buildings.[2] When, in the latter periods under an accelerated depreciation plan, the allowed expense is less than the actual depreciation, the difference "repays" the loan afforded by the allowance of earlier depreciation in excess of actual.[3]

Five-year amortization

There are several provisions in the tax expenditure budget which allow 5-year amortization. Rapid amortization reduces the taxpayer's liability by calculating straight-line depreciation over an arbitrary period—5 years—which is shorter than the actual useful life of the asset. Rapid amortization is a substitute for other depreciation which would have been allowed. In the $10,000 example, 5-year amortization would yield deductions of $2,000 in each of 5 years. Double declining balance depreciation would yield $2,000 the first year, $1,600 the second year, and declining amounts thereafter. However, the full investment credit cannot be taken if rapid amortization is used; the taxpayer has the choice of rapid amortization and a reduced or no investment credit depending upon the specific amortization statute, or whatever depreciation is allowed plus the full investment tax credit. If a $10,000 asset is eligible for the investment tax credit, an additional $1,000 of tax savings would occur in the first year. Thus, the investment tax credit plus the regular depreciation is likely to be better than 5-year amortization for the taxpayer in this case.

For a given asset, rapid amortization provides more tax saving the longer the asset's useful life and the higher the interest rate and the taxpayer's marginal tax rate. In the case of assets eligible

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[2] The explanation for this treatment is that the tax depreciation allowed for machinery and equipment is thought to be closer to actual depreciation than that allowed on buildings. See "The Tax Expenditure Budget: A Conceptual Analysis," *Annual Report of Secretary of the Treasury, Fiscal Year 1968*, p. 33.

[3] The taxpayer has the option to switch to straight-line depreciation of the undepreciated balance and usually may find it beneficial to do so. However, this option does not change the basic result; it simply increases the amount of interest saving.

for the 10-percent investment tax credit, it is unlikely the 5-year amortization provisions without any investment credit will be a better option. Where the investment tax credit does not apply to capital assets (such as housing rehabilitation expenditures), the 5-year amortization provision results in more tax saving than rapid depreciation if the asset's useful life is long enough.

Appendix C

CAPITAL GAINS

In the income tax law, profit from the sale of most investment assets is referred to as capital gain and receives preferentially lower tax rates. For individuals, this lower rate is about one-half the usual rate although capital gains may also be subject to the minimum tax on tax preferences. Corporate long-term capital gains are taxed either as ordinary income of the corporation or at an alternative rate of 28 percent, whichever produces a lower tax.

Broadly speaking, capital gain or loss is produced by the sale or exchange [1] of capital assets.[2] The sale produces "long-term" gain or loss if the property has been owned for more than 12 months. If not, it produces "short-term" gain or loss. While the expression "capital gains" technically includes both long- and short-term gains, it generally is used to mean only long-term gains. Only long-term gains receive the preferential treatment.

Stocks and bonds owned by casual investors usually are capital assets. Inventory owned by a retailer is not a capital asset. Between these extremes, whether property is a capital asset is less clear, and in specific cases, the definitional problem may be a very difficult matter. In general, however, the distinction is that investments are capital assets but items held for sale in a business are not.

Another kind of property that may produce long-term capital gain is property used in a business—generally real estate and depreciable property—if it is not held for the purpose of being sold to customers and is owned more than 12 months.[3] Gain on this kind of property is treated as long-term capital gain only if all of the gains for the year exceed all of the losses for the year. If so, the net gain is long-term capital gain.

The gain on a particular sale receives preferential treatment only if it survives a number of complex computations. First, losses on long-term assets are subtracted from gains on long-term assets. Only the net figure survives and is referred to as net long-term gain. Short-term losses which have not been used to eliminate short-term gains are then offset against this net long-term gain. After this offset, any excess is defined by the statute as "net sec-

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[1] Capital gain treatment is conferred only if there is a "sale or exchange." Other dispositions, e.g., an abandonment, do not result in capital gain or loss but rather in ordinary gain or loss. This technically is beyond the scope of this appendix.

[2] This gain or loss will be recognized and taken into income unless one of many nonrecognition provisions apply. Nonrecognition provisions are beyond the scope of this appendix.

[3] The holding period is longer for some assets, most notably cattle and horses.

tion 1201 gain" but is generally called capital gain and is entitled to preferential treatment.

For individuals, the preference is that 60 percent of the gain may be deducted, and only 40 percent of it is subject to tax. Tax reduction in the Economy Recovery Tax Act of 1981 reduced the maximum tax on capital gains to 20 percent. For corporations, the preference results by limiting the tax to no more than 28 percent of the gain.

The increase in value of capital assets is taxed as a capital gain only if the asset is sold. As a consequence, the gross gains on unsold assets accumulate in value without being reduced by any accrued tax.

Note: The following description is provided for the reader who wants a more detailed outline of the way capital gains and losses are treated:

First, the gain or loss must be determined on each transaction involving a capital asset. Then the following procedural rules govern the tax treatment of capital gains and losses:

(1) Long-term gains and losses are aggregated.

(2) Short-term gains and losses are aggregated.

(3) (a) If the aggregations in steps 1 and 2 both result in gains, long-term gain is treated as stated in step 4(a) and short-term gain is treated as stated in step 4(c).

(b) If the aggregations in steps 1 and 2 both result in losses, long-term loss is treated as stated in step 4(b), and short-term loss is treated as stated in step 4(d).

(4) If one of the aggregations in steps 1 and 2 produce a loss and the other a gain, the gain and loss are then aggregated, and the following rules govern:

(a) If the net is long-term gain, 60 percent of it is deducted by an individual in calculating gross income. Corporate long-term capital gain is either taxed as other corporate income or at the altenative rate of 28 percent, whichever yields the lower tax.

(b) If the net is long-term loss, individuals may deduct one-half of it from other income but not in excess of $3,000 per year. Corporations may not deduct any such loss from other income. There is an unlimited carryover to future years for individuals but no carryback. Corporations generally may carryback for 3 years and carryforward for 5 years, to offset capital gain.

(c) If the net is short-term gain, the entire amount is subject to tax.

(d) If the net is short-term loss, individuals may deduct it against ordinary income but not to exceed $3,000 per year, subject to the previously stated rules on carryovers and carrybacks. Corporations may not deduct any such loss from other income, subject to the rules on carryovers and carrybacks.

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